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IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

Part 2

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IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

TUESDAY, MAY 28, 1985

U.S. Senate,
Committee on Small Business,
Missoula, MT.

The committee met, pursuant to notice, at 1:30 p.m., at the Sheraton Hotel, Missoula, MT, Hon. Max Baucus (acting chairman of the committee) presiding.

Present: Senator Baucus.

Staff present: Tom Walsh, tax counsel; Michael W. Evans, legislative counsel; and Lawrence G. Dalsin, professional staff member.

STATEMENT OF HON. MAX BAUCUS, A. U.S. SENATOR FROM THE STATE OF MONTANA

Senator Baucus. I, first, want to welcome all of you here. This is a hearing of the Senate Small Business Committee, to discuss how current tax reform proposals affect small business.

It was Plato in ancient Greece who said, "when there is an income tax, the just man will pay more and the unjust less on the same amount of income." These words, I think, are even more true today than they were in Greece, because once again, Congress is reexamining the Federal tax laws. And once again, proposals for reform are causing quite a stir.

Tax laws are very long and complicated. The Tax Code, itself, is a 2,000-page nightmare. It is longer than the Bible, the Koran, and the Talmud altogether.

Tax regulations are five times longer. For example, the rules for the investment tax credit are 50 pages long. As one Montanan wrote me, "when it requires several pages to explain how to determine your filing status," the laws are too complicated.

Tax laws are also unfair. Two people earning the same income rarely pay the same income tax. Deductions, credits, exemptions, all encourage people to seek new ways to avoid paying their fair share. And wealthy taxpayers, who can hire experts to design elaborate tax shelters, wind up avoiding a large share of the tax they should be paying.

There's no question that Congress needs to overhaul the Federal Tax Code.

This evening at 6 p.m., President Reagan will propose a major overhaul of the Federal Tax Code. His proposal is most welcome. I applaud him for taking the initiative and making the difficult decisions needed to draft such a proposal. I think we can convert his proposal into a solid tax reform bill, if not this year, then next year. But now the hard job begins. Today's hearing is just the first step.

The Senate Finance Committee, on which I serve, will conduct 40 days of hearings this year. The House Ways and Means Committee will do the same. Then these two committees will begin writing a tax bill. After that both the House and Senate must pass that bill. Although House Ways and Means Committee Chairman Rostenkowski and Senate Finance Committee Chairman Packwood now say that a bill can be finished this year, I think it will probably not become law until next year.

Our goals are fairness, simplicity, and economic growth. But let's not kid ourselves. Sometimes fairness, simplicity, and economic growth all work together, but more often they collide. What is simple is not always equitable and does not always promote growth; and what promotes growth is fair, is often not simple. We, therefore, will have to make some very painful choices.

Today, in particular, I want to focus on how the President's proposals, as well as we know them before he outlines them tonight, affect small business. I want to be sure that tax reform is not a smokescreen for a whopping tax increase for small businesses. For example, I was appalled that the first Treasury proposal, several months ago, would have doubled tax rates for small business insofar as all corporations would have to pay the same flat rate of 33 percent; that is, there would be no graduated rates for corporations. I, however, will continue to fight to reinstate and to maintain graduated rates for small business.

Second, I want to achieve practical simplicity, not some economist's theory about simplicity. I want to know how tax reform can make your business decisions simpler so you can spend more time deciding how to produce a better product and less time deciding how to fill out tax forms.

Third, I am concerned about how tax simplication will affect Montana's businesses.

In recent years, we've used the Tax Code to stimulate new investment, to spur productivity, to strengthen businesses; but this has made the Tax Code more complex. As we works to make the code less complex, we must make sure we don't throw the baby out with the bathwater by eliminating incentives that work. We need reforms that will make us more competitive, no less—and that don't penalize or discriminate against certain businesses.

These are some of the issues I hope we can discuss today, and I want to thank the witnesses for taking the time to appear.

One final point, I think that Congress addresses the question of tax reform too often. I think that once this tax reform bill, becomes law, the Senate Finance Committee and House Ways and Means Committee should then lock up the hearing room doors and throw away the key for a few years. That way, we can let the new law settle and percolate so that we can find out what is working and not working. We should not come running back next year with a major bill and undo what's been done.

I think it is very important that the House and Senate hearings and deliberations on the President's proposal be very careful. We must take our time so that it's clear, because the proposal will be such a massive change in the American tax laws that it will take a good period of time for Americans to begin to understand, not only its first order but its second order and third order ramifications as they affect the economy and individual Americans, so that the Congress can make the proper adjustments and proper changes to better assure that once a bill is enacted we don't have to come back and reenact or redo it next year and the year after that.

Our first witnesses are Dr. Bruce Vorhauer, Mr. George Allen, and Mr. Norm Stedje. Why don't you begin, Bruce, and just speak for a few minutes; and then, we'll go to you, Norm, and then you, George. When you are all finished, then I might ask a few questions.

STATEMENT OF DR. BRUCE VORHAUER, CHAIRMAN OF THE BOARD, VLI CORP.

Dr. VORHAUER. I'm the chairman of the board of a public corporation called VLI which is a pharmaceutical firm that has developed a new drug product approved by the FDA and now on the market. I live in Montana by choice because I like the environment, although my offices are based in Irvine, CA, and most of VLT's 300 employees are there. We have about 300 employees.

We just opened a research laboratory here in Missoula in conjunction with the community hospital and have a evolving relationship with the University of Montana to research sexually transmitted diseases.

I don't have a prepard statement, but I'll make a few general comments about how I feel the tax reform—and obviously, my opinions are biased—will affect small business; when I started my company 9½ years ago, it was the ultimate small business. It was just me, and I did the research in my kitchen because I couldn't afford a laboratory. Eventually, I was able to obtain venture capital investors through the incentive of capital gains, and a subchapter "S" corporation which allowed them to have immediate deductions.

Over the period of 9½ years, I've raised $44 million in the venture capital to fund our operations. Some people say that's a lot of money. It is a lot of money, and I never would have been able to get that capital if it weren't for the incentive of capital gains, and the subchapter "S" provisions of the Tax Code.

I guess the bottom line, in my estimation, is the Tax Code should be not the stick, but the carrot. I believe very strongly in incentives. I think we ought to as much as possible eliminate the jealousy factor which oftentimes influences tax laws. One of the things I see as a major problem is the piece of anatomy on the front of our faces which we stick into everybody else's business. We should concentrate more on how to encourage economic growth in a positive environment.

A couple of ideas: Capital gains tax, if anything, should be reduced. My company, for example, has 200 employees this year and this year will do over $20 million in sales. We have developed a new feminine contraceptive, a new concept that has rapidly risen to the No. 1 position in its category in 1 year. None of this would have occurred without the capital gains incentives in the Tax Code, which encouraged people to invest in our business.

We are still a small business. In fact, we will be for some time. The tax load of smaller businesses, I think, should be made lighter. Providing more incentives and graduated taxes for businesses and individuals, I think, is a very good idea.

One of the things that concerns me in some proposals I've read so far is the decreased incentives for charitable contributions. I would like to donate a significant amount of stock to the universities that I've gone to, but it's almost prohibitive from a tax point for me to do that under some of these proposals. I think the Tax Code should have the philosophy of encouraging companies and individuals to donate to the arts, the charities, and our universities. The provisions in the Tax Code should encourage that, instead of discourage it.

I believe in paying my fair share; as recent as a couple of years ago, I basically was down to about three bucks in my checking account and owed a couple hundred thousand dollars. This past year, I paid enough taxes to pay the President's, the Vice President's, and several of the Cabinet officers, salaries for a year. I'm proud of that. I feel very positive about it. I think if you are lucky enough to be in that position, you should pay your fair share. And the Tax Code should take that into account. There should be no free lunch.

These are general statements, but, basically, you can see I'm very much in favor of a fair Tax Code providing incentives, rather than punishing success.

I have one last point on an international issue. We're one of the few countries that, in effect, penalizes companies for doing business abroad. We should provide incentives which would make it more attractive to distribute our products internationally. The current income tax code hassles, rather than rewards. I just came back from the People's Republic of China, and it became apparent that several investment opportunities there that I would like to pursue are not encouraged by our current tax laws. Our Tax Code should encourage exports, not only of goods, but of technology to the developing countries.

Senator BAUCUS. Thank you, Bruce.

Norm.

STATEMENT OF NORMAN STEDJE

Mr. STEDJE. I haven't got an outline and I'm the fourth man down on substituting in that regard.

Senator BAUCUS. You're probably better qualified, then.

Mr. STEDJE. Well, I'm not qualified as a tax expert. That's for sure.

I talked with our accountant in the business and I've been in the implement field for 35 years. When it comes to tax situations, we're kind of at the bottom of the boot. Farmers, likewise, and consequently taxes to us is something that we have to deal with. It's a necessary evil.

On the other hand, we really haven't got much alternative to pass on a tax load other than to the farmer, which hasn't got much choice either because his grain prices are set and cattle prices are set and his potato prices, usually, are set on the market. Consequently, if we sell pieces of equipment, we've got to sell it at the price that he can pay for it.

Now, through the years, yes, we've paid seemingly our share of taxes. We look at it from a tax standpoint and I don't think there's any Government agency that couldn't cut their overhead to cut the size of tax that we have to pay in order to support you. And I'm looking at you because you represent the Congress.

I think you've got a plan in Congress at this point that's workable. I was one of the members of a State council on the Governor's Council on Management when they went through the process here a couple years ago. And it's amazing the number of dollars that the State has been able to recover, not necessarily recover, but to ultimately get by with less taxation. And I guess that's what would be about what I have to say at this point. I just am not really qualified to speak on behalf of the taxpayers other than what I've said.

Senator **Baucus**. OK. Thank you.

George.

STATEMENT OF GEORGE ALLEN, EXECUTIVE VICE PRESIDENT, MONTANA RETAIL ASSOCIATION

Mr. **Allen**. Thank you, Senator. My name is George Allen and I represent the Montana Retail Association.

We want to thank you for the opportunity that you have afforded us in coming here and expressing to you the concerns of the small businessmen and businesswomen in Montana, who are mostly involved in the retail industry.

Collectively, the retailers in the State of Montana is the State's largest employers and the largest taxpayers and the largest contributor to the unemployment insurance fund. We feel that collectively we're really the backbone in Montana; but, in spite of the fact that collectively we are the State's largest employer, that the net income of some of these retailers, if they so desire, they could go and qualify for food stamps. It's been a tough few years in the retail industry in Montana.

You asked that I testify on the small business taxes, which we are required to pay. In attempting to get some input from the retailers, I went around the State, I made a few phone calls and talked to several of them. The comments that I received from them were somewhat shocking to me but I hope they will be interesting to you.

These are some of the negative comments I received: "George, why are you wasting your time in testifying on this? Why do you want to participate in this charade? The small businessmen will not get a fair shake on the proposed tax revision. These hearings are nothing more than a political platform to further someone's political career." There were some positive ones. Senator, these comments are coming from frustrated business people who have risked their entire life savings in the business they're working 14 hours a day, 6 days a week. They feel they are being neglected from the Federal level. As an example, they feel frustrated when they see the abuse of Federal programs, such as the Food Stamp Program, and the tremendous amount of waste that is going on in the Pentagon and overbilling by some big defense contractors.

They feel the so-called poor have the ear of Congress, the elderly have the ear of Congress, the big business with their powerful lobbyists has the ear of Congress, the big organized unions with their powerful lobbyists have the ear of Congress, yet the small retailer, the small business people, feel frustrated and ignored.

Senator, fortunately, most of the retailers, and I don't agree with all of these statements that have just been expressed to you; and I want to take the opportunity to thank you for what you did in repealing the Internal Revenue's Department ruling on recordkeeping when using your personal car on company business. That would have been a disastrous bookkeeping burden placed on the small businessman and farmer/rancher here in Montana. We applaud you on your efforts in getting that straightened out.

As your committee wrestles with these very complex proposed revisions in the tax laws, we hope you will keep the small businessmen in mind, the small retailer, the small employer. We're not looking for handouts or we're not looking for special treatment, but we are looking for and feel we have every right to expect fairness and equity in the future taxations. It is frustrating to hear about millionaires who pay no taxes, about big industry, through manipulating financial accounts, pay no taxes.

Again, we want to thank you for the opportunity to express the concerns we have, and we hope that when you take this information back to Washington and meet with your colleagues back there, you'll keep the interests and the thoughts of the small businessmen in mind.

Senator **BAUCUS**. Thank you, George.

The first question I have is for you, Bruce. You talked about capital gains treatment being important, maybe even necessary, to attract investment to help small business get going. Do you think that the present capital gains treatment should be liberalized? Should the capital gains tax be higher or should it be lower?

Dr. **VORHAUER**. The last provision I saw about the tax, they were reducing it to 17 percent. That's nice——

Senator **BAUCUS**. The top effective rate would be 17.5. That is, 50 percent of capital gains would be excluded as opposed to present law's 60 percent; but the top rate would not be 50 percent as it is the case with the present law; but would be 35 percent in the proposal.

Dr. **VORHAUER**. Seventeen and a half percent.

Senator **BAUCUS**. That's right.

Dr. **VORHAUER**. I think there should be capital gains treatment. Eliminating that completely, I don't think is fair. We need to encourage money to come into these investments; I think from my experience, it was crucial. We could not have done what we did without that capital gains tax incentive.

Senator **BAUCUS**. For a business like yours, you said it's important to have fair capital gains treatment. Is it also important to have an investment tax credit and accelerated depreciation? Which incentives tend to have more wallop?

Dr. **VORHAUER**. It's a very good question. The investment tax credit, to us, has been relatively unimportant. Our machines, for example, are a small cost compared to that required for, say, construction businesses as percentage of capital employed. Your technology incentive——

Senator BAUCUS. I would say that most of the Montana businesses tend to be in your category. There are no big steel mills or auto plants, which require heavy capital expenditures, for which the investment tax credit would be more important than for retail firms or other firms like yours.

Dr. VORHAUER. I'm relatively neutral on the investment tax credit either way. I'm more interested in major capital gains.

Senataor BAUCUS. How important is the R&D credit?

Dr. VORHAUER. Taking a look at the early stages in my business, there was nothing coming out for us. We haven't yet seen a profit in 9½ years. We will be profitable this year, for the first time. In that case, the R&D credits are very important because that can delay the tax that you'll pay in the future. Particularly, in a partnership where those benefits can pass through the partners.

Senator BAUCUS. Why do you maintain most of your operations in California?

Dr. VORHAUER. I happened to end up there.

Senator BAUCUS. Where did you come from?

Dr. VORHAUER. Boston. I went to work for American Hospital Supply Corp. and they were based in California. The other thing is that there's a critical mass there. It seems to me that you have to have a number of people involved in an area before things really start to happen. And that entire medical complex in Orange County developed when one man, Lowell Edwards, was on vacation in the 1960's in California, and he decided to develop a heart valve company based in Orange County.

Our laboratory here in Montana will hopefully encourage people to invest in biotechnology and medical products businesses once we reach that "critical" mass. We've got an incredible quality of living in Montana compared to what we have in California.

Senator BAUCUS. I know that's true. I have a sister that lives in Orange County.

What other changes can you recommend to provide more incentives? You seem to dwell on incentive treatment. Are there other kinds of incentives that you can think of?

Dr. VORHAUER. There are a number of them. As you know, I do not have a prepared testimony; but they all represent and encourage capital investment. The venture capital business is extremely important.

There is an incredible amount of money tied up in pension funds and other large money pools throughout the country that could be invested in growth opportunities, building new businesses. If there is anything that the Tax Code can do to encourage that money to be invested in creating businesses, that would be a win, long range.

Senator BAUCUS. What about savings rates? In our country, some commentators say that Americans are disadvantaged compared to Canada and Western Europe. Our personal savings rate is so much lower that our cost of capital and our interest rate tends to be a little higher than in most other industrialized countries; do you agree with that analysis? Do you think that the American savings rate should be increased, perhaps, and that the Tax Code should be utilized to help provide incentives so that Americans increase their personal savings?

Dr. VORHAUER. The IRA is a good example of that. The amount of money that came out of the woodwork to invest in IRA's is just incredible.

Money is fuel. Any time you can encourage that fuel to be used and cause some good to happen, that's great.

Mr. ALLEN. I think deregulation has been a positive step. Like the marketplace has found its own level and the savings and loans, the banks; I think this whole deregulation is moving in the right direction with the competition to establish those rates.

Senator BAUCUS. Some people suggest that the way to get business to expand, to grow, and to prosper is to lower corporate rates; others have a very different theory to promote expansion and growth and prosperity. Namely, that corporate tax rates should be relatively high; in comparison, individual tax rates should be relatively low. The theory is that corporations, especially large corporations, pass on their taxes anyway, in the form of lower wages or higher prices. So the theory is that lower personal rates compared with high corporate rates will encourage Americans to save more and everyone will be a little better off. That's the theory. I'm just interested in knowing if any of you who have heard that theory subscribe to it.

Dr. VORHAUER. Of course, it's true. If you tax a corporation, the cost of that tax is going to be passed on to the consumer of the goods or services of that corporation.

Senator BAUCUS. America has relatively low corporate rates and higher individual rates. Whereas, Japan and Western Europe is just the opposite. Those countries tend to have higher corporate rates and lower individual rates.

Mr. ALLEN. I guess, if the tax was a nationwide tax on corporations it would be fair; but you get into the State tax and we see where one State will make an advantage so that a company will put a plant in that State instead of another. Then, you have the company debating between two States and I'm sure that the taxation policy in that State is a big determining factor whether they go into that State or not. I think that is a positive thing if the "advantages"—or maybe that isn't the right word, but if the consideration can be given to encourage companies to invest, to create jobs, to get the ball rolling, we're in a better position than if we try to penalize that company so bad that they just say, "Hey, there's no incentive to expand. Let's keep our eggs in one basket and do the best we can."

Senator BAUCUS. At this point in the present tax law, the primary concern seems to be capital incentives. As a result, the retailing industry pays a higher effective rate than do some of the smokestack capital-intensive industries.

Of course, that is what the President was trying to address here. I assume that the graduated corporate rates is very important to small business.

Dr. VORHAUER. I think so, too.

Senator BAUCUS. Do you agree, George?

Mr. ALLEN. Yes.

Mr. **Stedje**. Family-type corporation, which there are a number of them in Montana, probably there wouldn't be as much of an advantage to incorporate if they're going to be taxed twice for the same money, so that would hurt our business. It would be bad for us to incorporate.

Senator **Baucus**. Let me explain what's happening. The President's plan, which he is going to announce today, will keep the same break points for corporations. That is, $25,000, $50,000, $75,000, and $100,000. The proposal however, is going to change some of the rates that apply at these break points. As a result, the degree of graduation will be more flat than it is under current law.

Now, that's going to be in the proposal and I'll be looking at it to determine its effect on small business. Let me shift gears now. What about paperwork requirements?

Dr. **Vorhauer**. Well, there are macroissues and microissues. Microissues, which face people most—and we, George and myself, were speaking about this earlier—are the picky details of the paperwork requirements; you know, it took $5,700 to get my personal income tax done this year. It was, like, 65 pages. You know the amount of work? I couldn't understand it, that's why I had to hire an accounting firm to do it. I'm not unusual. There aren't too many people who can do their own taxes these days because of the complexities. It's got to be simplified.

The recordkeeping requirement for business use of a car. I can't believe it. It is so ludicrous. And to think, there it is, a law. We've got to watch out for these kinds of things since they can cause people to react in an unreasonable and irrational way. When you feel this happening to you, there is nothing you can do except get your Senator to get the rule reversed.

Senator **Baucus**. I agree. I felt un-American when I had to hire an accountant to fill out my return. Up to 4 or 5 years ago, I could sit at the kitchen table and do it all myself. But a few years ago, I had to give it up and I felt unpatriotic. However, its very difficult to balance simplicity with other goals. For example, if you retain favorable treatment, you create a complexity. The same is true of many other provisions, too. So we have to figure out where to draw the line between simplicity on one hand and equity on another.

Dr. **Vorhauer**. You've got to start reversing the trend. It just keeps getting more and more complex.

Senator **Baucus**. And how should that be done? By eliminating a lot of the deductions and credits?

Dr. **Vorhauer**. For example, deductions for interest income. There, you're encouraging saving instead of borrowing. We were talking earlier that our savings rates were the lowest in the world until IRA's came along.

Senator **Baucus**. Well, that's still a problem, and is caused by both carrots and sticks. The carrot is the unlimited deduction of interest, which encourages borrowing. That's a big, healthy carrot. And the potential sticks are things like the Japanese practice of requiring up to 50 percent down when you buy a home or car.

Basically, the bottom line question here is: Do all of you feel that you're willing to give up exemptions, deductions, and credits in order to have lower rates and a more simple tax system?

Dr. **Vorhauer**. Yes.

Mr. ALLEN. I think so, yes.

Senator BAUCUS. Are there any exceptions, any areas——

Mr. ALLEN. Providing everybody is treated as equals. I think everybody ought to pay tax whether they're on the low end of the spectrum or high end. It just irritates me when you hear of very wealthy people paying no tax. I don't think that's fair.

Dr. VORHAUER. One good alternative to eliminate the skullduggery that's going on is the alternate minimum tax. Everybody complains about it but the provision is very fair because it makes sure that everybody pays. And corporations should be subject to it as well. But one effect I would be very unhappy about is an effective decrease in deductions for contributions. I think it's very important to encourage this.

Senator BAUCUS. What about fringe benefits?

Dr. VORHAUER. That's another one.

Senator BAUCUS. How important are they?

Dr. VORHAUER. I think they're very important for most people. To me, it doesn't make much difference; but if I am paying tax for somebody's free ride, I don't think that sort of thing is fair.

Senator BAUCUS. I'm talking more about health insurance premiums that are deducted by the employer and currently not considered income to the employee.

Dr. VORHAUER. That's an interesting question, because some people——

Senator BAUCUS. You mean the people who are self-employed who don't——

Dr. VORHAUER [continuing]. Shouldn't be subsidizing somebody else, and that's the problem.

Senator BAUCUS. Some people argue that if you don't tax health insurance premiums to the employee, that is good because it helps keep health insurance financing private, and the alternative would be health insurance financing by the Government sector. Is that an argument that you agree with or disagree with? What do we do with health insurance?

Dr. VORHAUER. If you make it not deductible, industry would pay a lot more attention to costs. For example, if it's no longer deductible, people will scrutinize just where that money's going and why it's being spent. In any large system there is waste, and that might cause some efficiencies to develop.

Senator BAUCUS. Health costs in America as a percent of the GNP has risen from 6 percent to about 11 percent of the gross national product today, but increased health care costs in the United States are now leveling off. They are starting to grow much less rapidly, because of hospital DRG's and lots of other developments. the question is: Do health care costs rise unnecessarily because of present law treatment of health insurance? Do you get any sense of that?

Dr. VORHAUER. I have a sense that there's a fairly good factor involved there. The attitude that it doesn't matter since it's deductible; this can distort the system and cause obtuse things to happen.

I understand the President's proposal is going to be business meals, $25 maximum.

Senator BAUCUS. Dinners, $25.

Dr. VORHAUER. Whether $25 is the right number or not——

Senator **Baucus**. Half of anything over $25.

Dr. **Vorhauer**. I don't know if that's the right number; but certainly, I've been involved in situations where there were meals that may have cost $150 a person, and you know, that's perverse. I don't think the Tax Code should be subsidizing and footing that bill.

Mr. **Stedje**. If we don't have premium deductions, you might say, for instance, there's going to be a lot more on welfare.

Senator **Baucus**. Because they don't have their own health insurance policy?

Mr. **Stedje**. They won't be able to in Montana.

Senator **Baucus**. This proposal, and I'm sure you know, is to treat the first $10 per month of premiums as income. Therefore, when you get your W-2, your employer is going to show your wages. Then, in addition, there will be another line which shows how much health insurance premiums that employer paid; the first $10 per month per person and $25 per family will be treated as taxable income. That's the exact opposite of what the Treasury Department had earlier talked about, namely, providing a cap, a yearly cap, I think, and monthly cap per person of $75 and a family cap of $175. That is, the first $175 for a family would be tax exempt with anything over being taxable. Now, we'ver just reversed it, saying the first $10 per month is going to be treated as taxable income. Any reaction to that?

Mr. **Allen**. Let me back up just a little bit. On the benefits, the value of the benefit to the employer, employee. Obviously, the employees think they are organized labor things. That it is very important. It is one of those things they always build into our contracts.

When you look at an employee making X number of dollars a year and has a lot of fringe benefits not included in his salary, and another employee who has none of those benefits is making the same dollar income, one is getting some favoritism there over the other one. So I would have no problem with including benefits in the employer's income statement, W-2 form.

Senator **Baucus**. Should that be counted as income, though?

Mr. **Allen**. Well, if you wanted to get fairness in it, it should be, because some employees get a better deal than other employees.

Senator **Baucus**. Just a few more questions here. What about the paperwork attributable to payroll taxes? Is that a significant burden, unnecessary burden, or is it just a part of the cost of doing business?

Under present law, if your payroll taxes are $3,000 or more per month, then you have to pay those payroll taxes twice a week to the Government, to Uncle Sam; but if your payroll taxes per month are $3,000 or less, then you make that payroll tax payment once a month. And maybe with modern computer age, it doesn't make much difference; but it seems to me that a business that has a payroll tax of $3,000 or $4,000 a month has to incur quite a burden in paying twice a week rather than once a month. It, also, is more paperwork. And the fact of the matter is, would you raise that $3,000 level up to $5,000 so that more businesses would have to make that payment once a month rather than twice a week?

Would that be a significant difference to enough small businesses or would it not be a significant difference?

Dr. **Vorhauer**. I've got a feeling that for smaller businesses, 10 or 12 employees, it would be very significant because cash flow typically in small businesses is a struggle. Our business is the true small business; I'd say it would be a very important factor. Anything to allow you to maximize your cash float.

Mr. **Allen**. And I think most of the small businessmen in Montana and businesswomen have recognized that they don't have the time or the expertise to deal with it and so they hire a CPA firm to take care of that for them. It is commonly indicated that they just don't fight it any more. They just turn it over to an accountant.

Senator **Baucus**. I think that's right. Anything else?

Dr. **Vorhauer**. Good luck.

Senator **Baucus**. OK. Let's begin. We have Michael Brown, business school; Martin Burke, law school; and Bob Bragg and Timothy Sather, CPA's in Missoula. There's no particular order here. Why don't you begin, Mr. Sather.

STATEMENT OF TIMOTHY J. SATHER, DOBBINS, DeGUIRE & TUCKER, P.C., CERTIFIED PUBLIC ACCOUNTANTS

Mr. **Sather**. As mentioned, I'm Tim Sather with Dobbins, DeGuire & Tucker, and I represent Montana Association of CPA's, and in that position I did some calling around and talked to other practitioners and with many of my clients to kind of get a feel for what's the main concern in the tax law and concern in some of the proposals that are being made by the Treasury and the Reagan tax plan.

The Treasury plan and the yet-to-be-said plan from President Reagan propose to reform the tax system to make it fair, simpler, and encourage economic growth. The seven major tax laws passed over the last 10 years have done just the opposite. There's very little confidence that this trend will be suddenly changed. There is tremendous concern that in the political process we will end up with a tax law more complicated and difficult to interpret and that the full economic impact of the changes will not be known.

As I mentioned, we've had seven law changes over the last 10 years. We have the Reduction Act of 1975, the Reform Act of 1976, the Reduction and Simplification Act of 1977, the Economic Recovery Act of 1981, the Equity and Fiscal Responsibility Act of 1982, and the Reform Act of 1984. I'm not sure that we can stand much more reduction, reform, equity or simplification. The Treasury proposal is named a tax reform for fairness and simplicity and economic growth. Based upon our past years, just the name alone says that this one is going to be a real doozy.

The tax system should foster an environment in which individuals and businesses can adopt an investment philosophy, elect investment strategy in vehicles, and monitor their movement toward their objectives. Because the tax law affects dramatically the return on investment. The constant changes in the tax law has disrupted this process.

The tax law, although not set in stone, should not be subject to the whim of the Treasury Department. My question is: Why do we need a revolutionary change in the system? It's kind of like the Treasury Department saying to the Americans, we have messed with the Tax Code for so long and now it's in such chaos that we need to start all over again.

How can a tax change, the Economic Recovery Act of 1981, that encouraged the formation of capital and directed investment toward fixed assets and real estate investment, following which we have a national economic recovery, require elimination? The change, which will have a negative effect on real estate, oil and gas exploration, and capital intensive industries, must be studied in depth; a real understanding of the impact of this tax change must be understood before enactment. And I shall state the following: "Economic science simply is not sufficiently precise to allow accurate prediction of the effects of reforms as fundamental and pervasive as those proposed by the Treasury Department; accordingly, this report contains no such attempt at precise quantification of economic effects."

I think this is very frightening. What if the effect is very disruptive and has a negative economic impact? Who is going to accept the blame? Any change should be made on an incremental basis, not one sudden change, the effect of which no one knows.

In western Montana, it's recognized that this is a capital-poor area, which is extremely risky to invest in. The changes in the various proposals which will impact investment strategy must be of major concern to each of us who live here in this area.

There are many various available equities, such as stocks, bonds, mutual funds, demand deposits, bank deposits, money market funds, real estate, tax shelters, and the businesses and collectibles.

If the effect of the law is to encourage maximization of immediate income, we may see less investment in businesses, equipment, and real estate in western Montana. In its place, the direction of investment may be more toward banks, money markets, and the national bond and stock market. This latter scenario will result in the exportation of Montana's precious and limited capital.

I'd like to give you some examples of what I feel might be the negatives if the Treasury proposal is enacted into law. It would have a negative impact on trucking, logging, and lumber production, all of which are responsive to the tax incentives or our required equipment acquisition in all our major elements in western Montana's economy. If the proposal is to tax over 35-member limited partnerships as corporations, and less incentives toward depreciation and investment credit, the Sheraton would not be in existence, or if it was, it would be owned by people for out of State.

The Tax Code should be used primarily to raise revenue to fund the functions of Government. As soon as the tax system is used to influence social and economic change, simplicity, confidence, and fairness goes out the window. The use of the tax system to influence social and economic change whould be used with great trepidation and restraint, and once such a change is in place, it should be repealed with the same reservations.

Senator BAUCUS. OK. Bob.

STATEMENT OF ROBERT B. BRAGG, INGOLD & CO., CERTIFIED PUBLIC ACCOUNTANTS

Mr. **Bragg**. Thank you for the opportunity to give testimony to your Small Business Committee regarding tax reform. My name is Robert Bragg. I'm a certified public accountant, a certified financial planner, a tax practitioner, member of the American Institute of Certified Public Accountants Tax Division, a lecturer in taxation at the School of Business, University of Montana, and a former IRS agent. I'd like to speak to you on four general areas: First, the public perception of the lack of fairness in the current tax system; second, the significant and adverse nontax effect of the major changes in the tax laws over the last 9 years; third, a nonpolitical approach to tax reform; and the fourth, the administrative impact of major law changes on the Internal Revenue Service.

First, unfortunately, the public perceives a great lack of fairness in the present taxing system. This causes the noncompliance and the creation of an underground economy, which is not reportable through normal channels and, therefore, not subject to taxation.

With whatever tax system that is finally passed, it is very important that Congress provides sufficient funding to adequately communicate the tax laws to the public so the perception of fairness is instilled in the mind of the American taxpayer. When I was a revenue agent in San Francisco and then later in Missoula, I was always impressed by the fact that 99 percent of the taxpayers whose returns I examined wanted to pay their fair share of their tax bill under the law. This perception of fairness is at the heart of the voluntary compliance that has worked so effectively in this country. However, the massive changes and complexity that has entered into our tax system caused by changes in the tax law have undermined that perception of fairness, regardless of the titling of the various tax bills, such as the Tax Equity and Fiscal Responsibility Act of 1982.

The second area on complexity. During the past 9 years, there have been five major tax revisions that have significantly affected the taxpayer, tax preparer, and the Internal Revenue Service. There have been three major changes in the tax laws during the last 4 years. The frequency and magnitude of these changes create uncertainty, confusion, stress, and frustration, which all lead to noncompliance. The magnitude of the last three laws, the Economic Recovery Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Tax Reform Act of 1984, have added complexity due to the sheer volume of changes as much as the actual changes to the laws themselves. For example, the Economic Recovery Act of 1981, Commerce Clearing House's version of the law and explanation, including committee reports, was 496 pages long. The Tax Equity and Fiscal Responsibility Act of 1982 was some 689 pages long. The Tax Reform Act of 1984, including committee reports, was 1,181 pages long. Significantly, the Commerce Clearing House concise explanation of the Tax Reform Act of 1984 was 448 pages long, nearly as long as the entire Economic Recovery Tax Act of 1981. Now, in 1985, both Congress and the administration are proposing the most massive changes to our tax system since the beginning of our tax laws in 1913. Based on an extrapolation of the size of the past three tax bills, it will be that the proposed 1985 Tax Simplification Act will run approximately 1,800 pages in length with the concise explanation running 680 pages. This will probably be followed by the Technical Corrections Act of 1986 and the Tax Reform Act of 1987.

I would recommend that unless the administration and Congress can realistically accomplish true tax simplication that there be a 5-year moratorium on the adoption of any new tax laws or changes to the IRS forms. At some point, there must be some consistency with our system and that consistency must be the first step to real simplification.

The third area. I am extremely concerned and disappointed about the political approach to tax simplification. All members of the Congress and the administration, as well as individual and corporate taxpayers, should aspire to achieve true tax simplification and fairness without advantages for a political party or pressures from special interests. I recognize, however, that this may be an unrealistic goal.

In that regard, I recommend that a bipartisan commission be established to study, for 1 year, a tax simplification program. The impact to our economy and to the taxpayers, as well as tax preparers, should be examined. Without such a bipartisan commission, I am concerned that the taxpayers and tax practitioners will be caught in the political cross-currents advanced under the disguise of tax simplification.

In the last area, in my former employment with the Internal Revenue Service, as well as my current dealings with the Internal Revenue Service, I have noticed a marked change in the attitude of revenue agents in regard to the system. Because of the complexities of the laws and the all-consuming tax shelter audit programs, the agents are getting very frustrated with the systems, as well as the taxpayer. This certainly makes it difficult for the administrators of our taxing system to function properly.

Tax simplification and a consistency in the tax laws are very important in order to achieve the tax fairness that we all desire.

Senator BAUCUS. Thank you, Bob.

Martin.

STATEMENT OF J. MARTIN BURKE, PROFESSOR, UNIVERSITY OF MONTANA SCHOOL OF LAW, MISSOULA, MT

Mr. BURKE. Thank you for the opportunity to speak to your committee on tax reform. I wish to address my remarks, specifically, to the matter of capital recovery and depreciation. As all business people and investors are aware, our Internal Revenue Code contains numerous provisions providing for the means of deducting the costs that are incurred in acquiring assets, such as equipment and buildings, which are used in one's business or for investment purposes and which have a limited useful life. A deduction of such costs is certainly consistent with the theory of our Tax Code which seeks to tax only the net income derived from business and investment. Since the cost of wasting assets used in a trade or business is a cost of producing income, a deduction for such costs is appropriate.

Generally, our Tax Code does not permit an immediate deduction of cost of such assets; but rather, authorizes a deduction of an asset cost over time. This arrangement is consistent with the notion that in determining a taxpayer's annual taxable income, one must offset the income generated during the tax year with the cost incurred to produce the income that year. Since the machine, for example, used in one's business will be instrumental in producing the income over a number of years, our Tax Code historically has required that cost of that machine be apportioned among the use in which the machine would be income-producing.

While this theory of depreciation seems reasonable, it's implementation has been cumbersome, indeed. Numerous problems have presented themselves: First, determining the useful life of an asset; that is, the period during which the asset will be income-producing has been very difficult. Second, determining an appropriate rate of deduction for each year of an asset's useful life has, likewise, created much difficulty. Over the years, Congress and the Treasury have utilized different means of addressing these problems. Prior to the Economic Recovery Tax Act of 1981, I believe that one could fairly say that the primary depreciation provision of the Internal Revenue Code, that is, section 167, and the Treasury regulations enacted thereunder, provided deductions, generally designed to approximate economic depreciation. At the same time, I must note that prior to 1981, there had been a tendency for Congress and the Treasury to provide for the use of shorter useful lives and higher depreciation rates in computing depreciation deductions. This tendency was a result of Congress' effort to stimulate and maintain a vigorous business climate.

Any notion that depreciation deductions should generally approximate economic depreciation were, in effect, discarded with the Economic Recovery Tax Act of 1981. As the name of the act, itself, suggests, our Tax Code was viewed as a tool for the implementation of economic policy. Indeed, long before 1981, our tax system has been used to effectuate both social and economic policies of our country, as well as serving as a vehicle for raising revenue to operate our Government. One need only look to provisions like the charitable deduction, the investment tax credit, or the exclusion for employer-provided health care insurance to see examples of social and economic engineering. Indeed, there are numerous provisions in our Tax Code which are intended to encourage certain kinds of activities. Our Tax Code does affect decision making. It is not neutral.

The Economic Recovery Tax Act created what is known as ACRS, the accelerated cost recovery system, which is found in Internal Revenue Code, section 168, and which represents the primary depreciation provision in our code today. Under ACRS, assets are placed in various recovery classes and a separate depreciation rate schedule is provided for each class. ACRS has the advantage of being simple in that it's provisions are relatively uncomplicated and easy to administer. As it's name suggests, the accelerat cost recovery system generally permits taxpayers to write off the cost of capital expenditures over a period much shorter than the actual useful life of the assets. Not only may the taxpayer deduct the cost of a business or investment asset over a shorter period of time, the taxpayer, under ACRS, may also deduct a very substantial part of the asset in the early years of recovery period. In combination with the investment tax credit, the deduction for interest, and the fact that under the Crane doctrine liabilities incurred in acquiring assets become part of one's basis for determining depreciation, and ACRS encourages business people and investors to acquire new equipment and buildings. Simply stated, the Congress, by enacting ACRS, agreed to forego revenue by granting very substantial deductions to business people and investors who would invest in additional machinery, equipment, and buildings. Such investments would create jobs and increase production, and in the long-run, I suppose, would increase the amount of Federal taxes collected.

I sincerely doubt that there is any way that one can measure accurately whether ACRS served its purpose. As far as the Federal fisc is concerned, there is no question there that ACRS has represented a significant drain. Last fall, then Treasury Secretary Donald Regan admitted that too much had been given away by Congress in 1981. In fact, before the ink was dry on the 1981 legislation, Congress, itself, realized that the combination of ACRS and investment tax credit provided, under the circumstances, a tax break even greater than if the law allowed the taxpayer to deduct the entire cost of equipment, et cetera, in the year purchased. Congress rectified this by amending and further complicating the Tax Code in 1982.

Aside from its impact on Government revenues, there is no doubt but that ACRS has represented a substantial plus as far as the tax shelter industry in this country is concerned. By utilizing leveraging techniques in conjunction with ACRS and the investment tax credit, taxpayers can generate very large deductions with very little cash outlay. That possibility has caused numerous taxpayers to invest in ventures which, but for the existence of tax provisions like ACRS, the taxpayers would not likely enter. ACRS, therefore, creates distortion in our economy, the effects of which we cannot measure.

Because ACRS encourages the acquistion of certain kinds of assets as opposed to others and because it encourages the purchase of new equipment to replace one's current equipment, I suspect that ACRS ultimately results in a waste of resources. Equipment, which is perfectly good, is discarded because the tax system makes it worthwhile to purchase new equipment. The waste engendered by ACRS cannot be measured, but I have no doubt that it exists.

In reflecting on our Nation's experience with ACRS, I see both pluses and minuses. On the plus side, ACRS is simple and it does stimulate investment. On the minus side, ACRS distorts decision making.

I have reviewed the proposals of the Treasury, that of Bradley-Gephardt, and that of Kemp-Kasten. The Treasury and Bradley-Gephardt would both significantly cut back the benefits taxpayers enjoyed under ACRS. I noted yesterday when I was in Billings that everything out of Washington and President Reagan will suggest a cutback in ACRS, as well. The Kemp-Kasten proposal would not make significant changes in ACRS.

Rather than comment specifically on any of these proposals, I would prefer to make some general observations regarding depreciation deductions and a tax reform in general.

First, broad-based tax reform cannot occur without significant attention being paid to ACRS. The distortions caused by the capital recovery provisions of the current law should be eliminated. This may be accomplished by implementing economic depreciation arrangement. In this regard, the Bradley-Gephardt proposal and the Treasury real cost recovery system merit close attention. Of necessity, proposals like the Bradley-Gephardt proposal and the Treasury proposal, in establishing methods for economic depreciation, rely on assumptions regarding the rate of inflation and the rate of return on capital assets in the economy. Such assumptions, obviously, create their own problems and to the extent that they are wrong, can create, in effect, a net subsidy or an additional tax to affected taxpayer. Approximating economic depreciation, nevertheless, seems a worthwhile goal and one which I would encourage. Methods other than the Treasury's or the Bradley-Gephardt's proposed methods should also be considered. Thus, for example, Congress might consider the possibility of allowing a single deduction in the year of asset acquisition. That deduction would be equal to the present value of future deductions for economic depreciation.

Second, I do not believe in the so-called tax neutrality theory that is being herald by many tax reformers. I consider it appropriate at times to use the tax system as a means of encouraging certain activity. Thus, for example, I am not troubled conceptually by the use of the tax system to stimulate the economy or to encourage charitable giving or to encourage the provision of health insurance. I think, however, that before the Congress adds provisions like ACRS, considerably more thought must be given to the impact of those provisions. One concern which I have, with respect to the present tax reform activity, is that there will be a substantial body of new tax law enacted without the kind of careful reflection that is necessary. The move for substantial overhaul of our tax system has gained tremendous momentum and I applaud that. There is no quick-fix to be had, however. I urge the Congress not to enact a major piece of tax legislation that will require countless technical correction acts over the next decade to remedy. We have had so much new tax legislation in the last 9 years that it is almost impossible for anyone to do any long-range tax planning or even to understand all of the changes.

Third, taxes cannot be so high that people are discouraged from investing or working. Even though our highest marginal rates of tax have been substantially reduced in the last year, the fact remains that tax rates are still quite high. By lowering the tax rates, I think, the Congress will find that there is less incentive for tax shelter activity and there is greater compliance overall with the tax law. In this regard, I agree with the modified flat tax proposals of the Treasury and Bradley-Gephardt. I believe some progressity is appropriate in our Tax Code. I would thus urge the rejection of the flat tax proposals before the Congress.

Fourth, I believe that careful study must be made of each of the special provisions which have crept into our Tax Code over the years. I am opposed to the wholesale discarding of all special provisions. Many provisions serve us well and should be retained.

Fifth, I believe that serious considertion should be given to eliminating the preference for capital gains. Preferential capital gain treatment accounts for much of the complexity of our code and for much of the tax game playing in which some taxpayers engage.

Finally, while it may be taken to an extreme, simplification of the Tax Code is, indeed, a worthy objective. A tremendous amount of Government resources are expended in administering our present complex system. Lack of compliance, economic inefficiency, and a widely shared perception of unfairness are by-products of the complexity of our tax system. Thank you.

Senator BAUCUS. Thank you very much, Martin.

Michael.

STATEMENT OF MICHAEL R. BROWN, PROFESSOR, UNIVERSITY OF MONTANA

Mr. BROWN. Senator, I'm Michael Brown and I'm a professor at the University of Montana. The views I present in testimony today represent, simply, my prsonal opinions and not those of my employer, nor any other group.

I am sure that we will hear a call this evening for major tax reform and simplification. I agree and strongly support the need for both. If one believes newscasters, we will also hear a call for swift action on the proposed reform and simplification. I do not agree with the call for swift action. Let there be no doubt that the tax reform and simplification are needed, but those changes need to be meaningful, understandable, and workable for the taxpayers who must comply.

I became a CPA almost 21 years ago. For at least that period of time, I have watched with great interest the changing tax laws. We have seen an ever-accelerating pace of tax changes. As you well know, in less than the last decade, there have been five major tax laws; in the last 4 years, there have been three substantial tax laws. Let us not exacerbate those changes by further embarking upon rapid change followed by even more change to correct the errors that we have made. But rather, let us come up with a change in the Internal Revenue Code that is fair to the taxpayers, that the taxpayers can understand, and which is not burdensome in its compliance obligations.

As we look at tax reform and simplification, my experience as an educator forces me to look at the objectives we should be attaining. While there are many measurements which might be used to constitute a good tax or what constitutes a good tax, I choose to look to something that Adam Smith came up with a long time ago. They sound very similar to remarks that I've heard the other speakers say. He suggested that we needed to look at equality, certainty, convenience in payment, and economy and collection. If we could satisfy those criteria, we had a good tax.

Traditionally, we have viewed the income tax as satisfying those criteria. I doubt that many comments taken today would say that it does.

We hear calls for reform because of real and perceived concerns about equality and fairness of the income tax. Where shelters are allowed to exist for the wealthy but are eliminated for the average citizen, the inequity of the system is bound to be subject to criticism and diminished voluntary compliance. The system must be fair to all taxpayers, not just the poor and wealthy, who can obtain the attention of the policy-determining bodies.

The certainty of the manner and the amount of tax on a given transaction is diminished when we have rapid changes. That is the history of the recent legislation. I believe that it especially hurts the small business persons as they attempt to determine and understand the tax consequences of their particular business transactions.

We have generally assumed that there could not be a more convenient payment form than "pay-as-you-go" withholding and estimates. But as the law becomes more complicated, assessments, interest and penalties will become more difficult for small business persons who will find themselves caught in an unsuspected tax trap. And the wherewithal to make those payments will indeed be a burden upon small business.

The Federal Government's administrative cost of collecting the income tax has historically been low; and, therefore, the tax has been considered effective and good. But frankly, you have shifted a significant portion of the burden of the compliance cost to the taxpayer. As the tax laws become more and more complex, the cost of obtaining the data necessary for accurate compliance becomes more and more expensive. Even after the data is collected, the cost of placing the data into a correct compliance form is expensive, especially expensive to the small business person.

I have intentionally avoided the discussion of specific tax topics, such as depreciation, itemized deductions, and credits. I do not believe those individual topics to be nearly as important as the necessity for the development of an intelligent, rational tax policy. We badly need tax reform that will restore confidence in the fairness of our tax system. We badly need simplification that will lessen the burden of compliance for all taxpayers. We very badly need certainty in the tax system. When we embark upon our proposed course of change, we need to have carefully determined that we have accomplished the changes that we desire and that we continue with those changes for a reasonable period of time without further major change.

We need a policy that is well thought out, that has allowed for input from all impacted segments of our economy, and that has allowed for adjustments that meet the genuine needs of particular segments of our society. But those special interests that are addressed and handled need to be intentionally decided as matters of long-range policy and not merely the result of particularly effective lobbying groups.

I have on my office door a cartoon, which I think says a great deal about our national attitude toward the income tax. A business executive is explaining the realities of the world to his son. "There is no such thing as a free lunch, but with a little effort it may be tax deductible."

Unfortunately, too many of us believe that the Tax Code should provide something for all of us. We need to return to the days when we limit exclusions, deductions, and credits to items of well-considered national policies and not merely the reflection of special interests.

We need tax reform. We need tax simplification. But we need to accomplish those changes with reasonable debate and understanding of the issues. We need to stop annual tax reform acts.

Senator BAUCUS. Thank you very much, all of you. We will break for about 10 minutes and then I've got lots of questions to ask.

[Recess taken.]

Senator BAUCUS. I'd like to start out with the general subject of how the proposals, as near as you understand them, affect Montana business as opposed to business in other States. I guess, I'm speaking, specifically, about graduated rates or about the effect of eliminating the investment tax credit. What effect that has in Montana compared to other States. The abolishing of capital gains treatment for timber. What actual effect that will have in Montana on payroll taxes and how they're paid, the rate of payments, et cetera. Basically, if you can just generally address how the proposals, compared to current law, affect Montana business as opposed to business in other parts of the country.

Who wants to begin?

Mr. SATHER. One of the questions that was asked during break or was just talked about was the elimination of the capital gains treatment and its effect on timber. As far as, in my experience—and, Bob, I'd like to have his thoughts on this, too—but I think it will have a minimal effect on timber sales just because it may affect a few farmers, but basically, most of the timber that is acquired in Montana is Federal or large corporations, such as Champion or like that. So as far as its effect on timber, most of the clients I have, I think it will be a minimal impact. I don't think they would be the ones to make the decision whether to sell their timber or not to sell because of the capital gains treatment on the graduated income taxes. As far as how they affect corporations and that sort of thing, I think it's important that the corporations and the individual rates in those top brackets should be somewhere in relationship to one another, because if they get way out of line, you'll see us going to the same position of should we leave the money in the corporation or should I take it out, individually, and that sort of process. And if I take it out of the corporation in the form of a salary, then I would pick it up as income at the individual level. Those rates in the top bracket ought to be somewhere in relationship to one another.

Senator BAUCUS. The proposal would lower top marginal rates to 35 for individuals and 33 for corporations.

Mr. SATHER. And I think that it is positive to have those in some kind of relationship to one another. I think it's important to have graduated rates. The major problem in Montana is the development of capital and especially in new small businesses. We've talked about some of the things in Japan, and I'm not an expert, but some of the things I've heard is they have the situation where, in order to start a new business, you have a moratorium on taxes for a period of time so that business can kind of get up and running. I think that's one of the most difficult things in a brand new business is to develop such capital in order to make those payments. I think that's very difficult.

Senator BAUCUS. That adds complexity, though.

Mr. SATHER. I'm not suggesting that. What I'm suggesting is that we have graduated rates, that we have small sections in the $25,000, $50,000, and $75,000 range so that businesses that are bringing in a smaller amount of income can develop capital without having to pay out large amounts of money in the flat 33 percent.

We've discussed investment credit and depreciation. I realize that it can be described as under the benefits that people get being in certain types of businesses; if you are in the service business or retail business, that's low capital needs for equipment and those sorts of things, that you may not get the advantage with depreciation and investment credit; but it can be a tremendous incentive and advantage for people who are in heavy capital intensive businesses who, again, are in Montana, maybe where capital is not at. Where it's a premium and you have somebody that is developing a business without a lot of capital, it would be an advantage to him. If we can get the assistance that you get from investment credit, then the incentives and advantages are there, too.

Senator BAUCUS. But, again, sticking with small business, what are the effects? Bob, do you have any comments as to how present proposals, as well as you understand them, compared with current law, affect Montana business as opposed to business in other States? I'm trying to find out how the new proposed changes, of which 75 to 80 percent of which probably will be enacted by the Congress, will affect Montana business?

Mr. BRAGG. Well, I think one of the premium needs here is that I think every one of the speakers on the panel has spoke about fairness and that the people in the earlier panels were talking, that we're all going to have to compromise with respect to elimination of capital gains treatment for timber that is proposed. I would imagine that will have an adverse effect on western Montana because our economy is so dominantly affected by the lumber industry. On the one hand, in order to achieve the fairness, we will need to probably go along with that. That's probably something that will have to be given up.

I guess, if you're looking at agricultural, where we're looking at cattle, in section 1331, that is a capital asset, also. The capital gains treatment will also have an adverse reaction on that if it is eliminated. So, maybe we're getting down to the definition of what should qualify as a capital asset, and I think it's difficult to identify what specific reaction these provisions will have. It's just as difficult to measure that.

I am in favor of the graduated tax rate. We do need some incentives for small business. We absolutely have to have it. As Tim mentioned, we do need some incentives for capital formation. If wer're talking about the next decade and the entrepreneur, we're going to see many small companies formed across this country. If we're saying that one of the advantages that we have if we don't have capital here in Montana, we certainly do have quality of life.

There needs to be some incentives for the capital formation, incentives for small business. More so than there is now.

Senator **Baucus**. Now, where would you pinpoint additional incentives? Where would you suggest that there be additional incentives?

Mr. **Bragg**. Well, I think there should be some incentives for people making investments into small businesses. Now, whether that be in the form of tax reform or in a tax exemption on the return that might be gained on those moneys either invested or loaned, that could be one possibility. I know that the ACRS provisions have been advantageous to small business.

Senator **Baucus**. Would you lower capital gains rate or increase it or shorten up ACRS? You mentioned deferrals as a technuque. I guess I'm curious if you would go with one or two or three incentives?

Mr. **Bragg**. Well, going back to my initial comments, I think if we're going to get into the Tax Code and look at specific elements that we have right now, and either propose to modify them or eliminate them, I think we're going to have the same problems that have taken place in the last 10 years here with our tax legislation. I'm very concerned about that and that's why I think there needs to be some type of a economic impact study that is undertaken by a bipartisan commission in order to examine the effects on small business and other aspects of our economy as well. And I really find it counterproductive to identify these items or suggestions and the specific laws without having first done that, without first studying our entire code.

Senator **Baucus**. Well, it's an interesting idea and also has a lot of merit to it, but it's fairly clear to me that there are a lot of forces pushing Congress to enact something quickly, in the name of simplicity. And it was a bit surprising to me when I learned that the Treasury had done no economic analysis at all with these proposals. In fact, I asked that question as soon as the Treasury proposal came out. How this affected Americans' competitive position with other companies, American companies, and overseas. They hadn't thought of that. And I don't think they thought of it much more in addressing Treasury II, either. The main emphasis in the Treasury II is a lot of compromise. Compromise between present law and "true pure reform," just a political compromise. That's what it is. The corporate/individual transfer is being narrowed, in Treasury II compared with Treasury I. There's not been much analysis of how this is really going to affect the American economy, so I think a bipartisan commission makes a lot of sense.

That's what they did with Social Security. They had a bipartisan commission with broad representation and I think it was a very good, sound study. And it helps Congress to take most of the politics out of Social Security. And because of what the Commission came up with, the Congress and the White House realized the better adopt it in total.

Mr. **Sather**. I think that the main thing that we're all concerned with is that there's so many alternatives out there, and as far as a tax change and what you are going to end up with, may be worse than what we already have. It's like we're throwing everything into a room and hoping something good might come out of it. I think we should just do away with the 1984 Reform Act and let's stay where we're at right now as far as one person's opinion. But that's what we're afraid of. That we will have a lot worse tax system, economically, than we do now and what is the impact of it.

We may get 2 or 3 years down the road and maybe we will be in a lot better position; but is we're not, I want to know who I'm going to blame.

Senator **BAUCUS**. It's hard to resist the political pressures in the Congress. The point is, to do something that we won't have to undo.

Mr. **BURKE**. I certainly agree with what Tim and Bob have said regarding small businesses, and they certainly are in a better position than I to evaluate that. I teach in a law school and some people will say that our heads are up in the clouds someplace.

A few points, though, that I think are worthy of mentioning; first of all, listening to Tim and Bob, it's pretty clear that there have to be continued incentives in our taxes so that we can encourage small businesses to that we can encourage capital formation. And that's saying, then, that tax neutrality doesn't make any sense. We have got, in fact, simplify our economic policies of our Tax Code. I think I agree with that.

Senator **BAUCUS**. What about the old point that many raise, and you somewhat touched on it, that the present tax law, as it affects business, is very unfair because different businesses pay very different effective rates. For example, many capital intensive firms are paying lower effective rates as compared with less capital intensive firms, retail firms, et cetera. Is that fair or unfair?

Mr. **BURKE**. Well, it is. But I don't think it's fair to take ITC and ACRS and how those provisions impact that carrot is fair, because they clearly encourage capital incentives. My only point is that let's forget the new tax neutrality notion and let's recognize that we want to use our Tax Code to stimulate industry; but let's do it and use a fair manner as possible. I think that can be done.

Let me just tie into something else, and I love Bob's idea of the economic impact study. If you look at ACRS just as an example, the legislative history of ACRS suggests that the Congress put very little thought into what impact it would have on the various resources, what impact across the board that ACRS would have. There is no measure to that impact. I would submit that we can't measure how many people chose to build a new home or how many people chose to build new buildings because of ACRS as opposed to refurbishing an older building.

Capital gains, also, is a classic example. IRS statistics for 1983, which I believe is the latest complete statistics, show that in 1983 there were about 5 million individual tax returns filed and about a third of those people, and I'm speaking of the common individual, that could use the 1002 capital gains form. Out of those 5 million, just a few used the 1002 in 1981. Likewise, the Internal Revenue Code, I would guess that somewhere in the neighborhood of 40 percent because of the complexity of that code, is a function of the existence of capital gains, that few people relatively speaking use capital gains. I think something has got to give and I think we're talking about we've got a serious problem and a change will impact, clearly, certain industries and certain individuals.

Senator **Baucus**. Can a capital gains provisions be made less complex, or must it stay necessarily complex?

Mr. **Burke**. Well, Congress has preferential treatment for income-tax payers for certain kinds of income——

Senator **Baucus**. But still, does the code need be that complex?

Mr. **Burke**. It seems like that Congress has gone and enacted the regulations as opposed to enacting the statutes and that enactment of the regulations recently is almost as though Congress, itself, is providing regulations for us. I agree, Senator, that it can be simpler; but maybe not as simple as we might like it.

Senator **Baucus**. Mike, do you have any comments?

Mr. **Brown**. I think the reduced tax rate that was reduced in all brackets have helped Montana business; and I think it's significant. And I think the tax rate remains too high, and I do not advocate a flat tax. In fact, I tend to point out that the people that we—if we look to the existing corporation tax law, we're about 1.4 million. Now, the tax rate is, in fact, a flat 19 in the corporation law. And so, flat tax has nothing to do with simplification.

I don't know what amount is progressive, but I suspect that it's been a long time since we've put incentives in capital gain and incentives in certain activities and we've had to grant relief so that taxpayers would engage in these activities. Clearly, we need to take time and look at what would be a reasonable rate.

I have a quick comment in terms of 1231 clarification of capital gains treatment and the timber and livestock, as well. I am certain about their removals in terms of western Montana; I think that puts us at a disadvantage in terms of agriculture whose investors would, in fact, be in the breeding of livestock and now not being able to get the same kind of treatment, in effect, as their counterparts, and the same is true of timber. I think timber needs to be held so long as in that it does deserve different classification.

Senator **Baucus**. So you think that even though you could simplify, you should keep those portions that we like.

Mr. **Brown**. What we have now, I think they're ressonably clarified. And certaintly, if we were to eliminate capital gains and that would include elimination of capital gains for timber and soils.

Senator **Baucus**. How desirable is it for the Congress to try to establish which portions of the code are good and should be continued and which objectives are not good and should not be kept in the code? And maybe some that are questionable. Let's us take the first category. Can any of you tell me what are some of the social objectives that you think should be continued and should be in the code, or tell me some that aren't in the code that you think should be included.

Mr. **Burke**. Charitable deductions. We are talking about the deductions that accounts, well, again, in 1983, 30 plus million Americans. That is almost $80 billion—no, about $90 billion—who claimed charitable deductions. That is a very significant number of dollars contributed to charity. That deduction makes total sense to me. And, in effect, the people are nominating which charitable deductions they want to contribute to rather than the Government saying which kinds of activities on a social nature we're supposed to support. The people, themselves, are going to decide that and that makes sense.

Senator BAUCUS. Anybody disagree with that?

Mr. BROWN. To some extent. I think we create a number of hazards in that I might to support a sports stadium with a substantial amount of tax dollars where a library may be sitting that is critically short of books. I will make that decision, now, as an individual in terms of dollars.

Senator BAUCUS. Even though the deducations should be maintained, the definition needs to be tightened?

Mr. BROWN. The definition, perhaps, even the limit. If my hobby happens to be—well, I need to have a different kind of hobby, I suppose. My point is, maybe we need to examine what we're doing with our charitable contributions.

Mr. SATHER. I'm not hung up on the theory, but the impact aspect. I think that the contributions are deducted as itemized deductions has an impact on whether people make them or not. People are going to make them as long as you retain them as itemized deductions. If you start to limit them, then there will be the impact of, should I or shouldn't I, and I'm not going to make that decision.

Mr. BRAGG. Well, I think I'd like to get back——

Senator BAUCUS. You don't want to answer the question.

Mr. BRAGG. No, your question is well taken; but let's approach it from a different way. We have a multiplicity of objectives in our tax law and we first have the 13th amendment, which gave Congress the power to levy and collect taxes. The 16th amendment, excuse. And Tax Code section 61 says that, basically, income is taxable from whatever the source and the various exemptions, and since then, we have had this patchwork of special interests in items, the items of what should or should not be deductible or taxable. The deductions and the exclusions. I think your question is an excellent question that we should look at and from the national scope of what we've talked about here is that tax law does influence charitable behavior. And whether or not the charitable contributions is deductible will also influence this behaviour, so what are these goals? What are those long-range goals that we want to influence behaviour in this country, and that is the type of dialog that needs to take place before we can achieve tax simplification.

Senator BAUCUS. The train is moving out of the station. The President is the conductor and the engineer. I don't know exactly where the Members of Congress are, but they are on the train. And as much as I think it makes sense to have a 2, 3, 4, 5, years bipartisan commission, I don't think this President or this Congress is going to wait that long. So we've got to make some decisions this year and next.

Mr. BRAGG. I think that's truly unfortunate because I think that just in the last 4 years these three tax laws have created some major problems is what I'm saying and that all of a sudden—if we've got a train pulling out of the station, I mean, someday someone is going to have to say, we've got to stop this train. We just have to have a 5-year moratorium. Even to keep it in place with what we've got right now. I would like to put it into legislation that you cannot change the law for another 5 years. And you're looking at the reaction here today that let's lock up the Senate Finance Committee and the House Ways and Means Committee for a period of time, and I think that's an excellent suggestion. I guess, I just want to reiterate on the point, that it is a critical nature of where we are right now in taxes. And the tinkering that is going on in Congress with this and if we're going to come across with more tinkering and more adjustments under the disguise of tax simplification, I think we're making a major mistake and it is going to have a detrimental and adverse effect in this country.

Senator **Baucus**. I think you make excellent points, Bob, but if we can't stop the train, I'd like the benefit of your sage counsel as to the kind of preferences if any, that you think should be maintained.

Mr. **Bragg**. Well, I think contributions; but as far as Montana and small business, I think there would need to be incentives as we mentioned before in capital gains. And for new businesses, incentives for small business for new businesses so that these businesses could be more economical, and so they can develop, and can pay taxes, and can finance the Government.

Mr. **Sather**. In the area of itemized exemptions, I think that interest as it relates to investment is very important. We've got a myraid of investment interests and those sort of things, but people who borrow money to use it to invest is an important aspect of the economy in Montana.

Senator **Baucus**. Since the President is going to keep the mortgage interest deduction for the first primary home, then limit it for the second home; I guess to $5,000 a year; and I think cut back severely the interest deductions for consumer loans; I'm curious what your analysis is of this.

Mr. **Sather**. I'm not hung up on consumer loans. In effect, what we're doing is listing deductions that are over here and we have a tax rate and we go and we change our tax rate, OK. Then, I'm saying OK. Fine. If you take this one and drop my tax rate 2 percent, then it makes it fair and I recognize that and that's fine, and if you can sell them that, maybe we can do it; but what I'm saying is that once you decide that we need to retain the contributions and the ones for interest and the deductions for investments, OK. If you want to take away the ones for consumer financing, then take it away but give them a lower rate. If you can take away insurance and give them a lower rate, we can do that; but I think it is extremely important, and I am just passing on people's remarks.

Senator **Baucus**. Employer fringe benefits.

Mr. **Sather**. I would do away with them. Because they're going to get the deduction whether they pay it in the form of health insurance, disability insurance, or wages. It's going to be the same deduction. There's not going to be any difference in the amount of income that's going to be reported for the individual or employee, and so if we can have those be taxable and lower the rates, then I think the average person is going to end up in the same place.

Senator **Baucus**. Any disagreement?

Mr. **Brown**. In fact, I think it would make the system a little fairer. Self-employed don't have it in the part of his health insurance and doesn't qualify for a medical deduction, but has the same income as a person who is provided his insurance and is, in essence, really has less take-home pay but the same tax. I think taxing those would, and I'm referring to section 61, concept of income from whatever source derived.

Senator BAUCUS. How about deductions for State and local tax?

Mr. SATHER. Eliminate them.

Senator BAUCUS. Anybody disagree?

Mr. BURKE. Let me make a comment on that fringe benefit issue. I tend to agree with both Tim and Mike that there is an unfairness that's created by those things. There's no degree of erosion of our tax brackets on fundings of fringe benefits of Congress, as you well know. The last section, as part of that tax reform code, in fact, provided an exclusion for common fringe benefits. I would love to see the dollar amount of reductions in Federal revenue that really represents it.

At the same time, I guess, I'm struck by the fact that those employers who provide health care and that kind of thing in today's society makes some sense just in that health care costs are enormous and, like Social Security, is kind of one of those things that people need.

But the problem, of course, with employer-provided health care is that some of the people when they have got health care insurance available to them think they can run into the hospital or into the doctor's office any time they want to; and maybe, we've abused that. But I think that we should preserve some of those fringe benefits.

As far as the State deductions or State and local taxes is concerned, clearly, it's a plus for the State and for the local government just from the standpoint that it makes that local tax collection a little bit easier if I know that on the Federal return I can deduct the amount of State taxes. It makes it a little more palatable to pay those taxes.

Senator BAUCUS. Let's go down and see what you think should be excluded from the code.

Mr. SATHER. The original issue disount rules that we just enacted, the employee market interest rate.

Senator BAUCUS. Imputed interest?

Mr. SATHER. Business computed interest, no, now that we have business computed interest. The section which eliminates installment reporting in relationship to 1231 assets, 1245 recap. It's been a real detriment to people that are selling a business or property in Montana, which, again, are capital poor. You're looking at an owner-finance situation where your downpayment is less than your tax costs, and that's very—creates some real serious problems in trying to get owner-finance sales to take place.

Senator BAUCUS. What about IDB's? They're scheduled for termination.

Mr. BRAGG. It is probably—as we go along, we're going to have to eliminate some of those things if we're going to have capital formation for small business. I guess these are the type of things that provide lower cost financing. I guess as we see it, if you call it small business, but a lot of the small businesses here in western Montana do not really fit the industry revenue bond scenario. A lot of the industry revenue bonds we have seen are really fair-sized organizations. We don't really see too much of that well characterized here in small business.

Mr. **Sather**. They can't afford to go through the process to progress.

Mr. **Brown**. They're just trying to make it.

Senator **Baucus**. Although I must admit that I pushed hard for IDB's because as part of the last tax bill Chairman Rostenkowski wanted to impose $150 per capita cap and we were able to beat that one down.

Mr. **Sather**. Just to go back and touch base again, I guess I tend to feel that that's where all the wealth in the country really develops from, from business, from our being able to perform and do business and those sorts of things. We seem to put business and individual taxation into a competition with one another and tax businesses in some way or another. I think the lowering of the tax on business means that more money is available potentially to go back into the business.

Senator **Baucus**. You think that some of these proposals might divert capital away from Montana and toward stock? Is that because of what? Timber capital gains?

Mr. **Sather**. I guess where I'm thinking is more in the area of there are some rules that they're talking about in there that says less than 35 unlimited partnership investment, and what that means is that, again, you can't grapple.

Senator **Baucus**. I think that's going to get axed. It won't survive.

Mr. **Sather**. That is an advantage. I think the ones that encourage people to go into business, and put money into business, and into property are better than if they put it into the New York Stock Exchange; I don't think Missoula, MT, will get any advantage from it. Or by putting it into the bank, I think there is a limited amount that the banks are going to utilize in Montana and probably that the banks are willing to loan out right now; they're moving more toward the demand deposits and is a lot of what is being taxed.

I think we should look more toward immediate income production. That's what we want to achieve is that people get an immediate result back from the income they produce so that there's more of direct relationship, that I want to put my money into whatever will give me the highest rate of return faster to offset that and to decrease investment in fixed assets, equipment, and those sorts of things is going to have negatives.

Senator **Baucus**. I sometimes wonder how important it is to maximize immediate returns. Sometimes I think that our bias toward immediate returns is one of the reasons we're getting beat by the Japanese and by Western Europe. I think there's too much of an ethic and too much of a culture in this country to have immediate gratification as opposed to longer term results. I don't know whether the Tax Code or other legal incentives should be enacted or not, but the more I study it, the more I think that, if we're going to remain the biggest, strongest, and most economically vital country in the world, we're going to have to think a little more in longer terms and look for results that pay out in a few years from now. Which means that we may have to create incentives to encourage new systems which pay on a longer term.

Mr. **SATHER**. But I'm saying that the thrust of the new law is that. That's what they want to achieve. If you put your money into the highest rate of return, then the faster that we can put our money maybe into real estate, and the stock market, and those kinds of things, which have been, in the past, a tax incentive, maybe to keep my money here, locally, and invest it locally. Maybe eliminate the new changes in the law.

Senator **BAUCUS**. Michael, you talked more about compliance and a little less about capital gains incentives and so forth, if I understand you correctly. The question is, how do you increase compliance?

Mr. **BROWN**. I think part of that issue, Senator, is the frequency of change. The sale issue of the recapture of ordinary income, for example, if I were a small businessman that last year made a sale and missed the major call date on sales of March 31 or something, all of a sudden that not only do I have more tax due because of recapture of ordinary income but 5 years from now, I can get the capital gain but not this year. The transaction seemingly disappears in terms of certainty and predictability. That's what I'm concerned about. If I had a client come to me today and ask me if a transaction would have a large capital gain, I'd have to say what I thought about it that date. It would be necessary for me to read a computer terminal every morning and I don't think that I have a client that can afford me to take the time to do that.

Mr. **SATHER**. If I have a client who comes in and asks how should I invest over the next 5 years, I have to say, "For the next 6 months, you're OK in this area." You used to be able to say where you should go and now you say, well, this is the tax law on that and what you would have to use for these investments. And I think that is a real major problem.

Senator **BAUCUS**. Basically, what you are saying is that Congress should try and not go through all of this but to have no other changes for 5 years. You're saying maybe it's not worth the effort and the change. It's more complexity, it's more uncertainty, and the result is going to be kind of a hodgepodge.

Mr. **SATHER**. I already stated that if we eliminate the 1984 Reform Act and stayed where we were, everything—we'd be a lot better off. I'd like to repeal 1984 and head forward and maybe if we need to say that ACRS is too aggressive and we're getting too many deductions, then we can shave that back a little bit; but the concept of ACRS is good.

Mr. **BRAGG**. I think the report card on past tax legislation has been very poor, and what we're saying is, we really don't have confidence that the changes that are being proposed will, in effect, bring about simplicity, true simplification.

Senator **BAUCUS**. And that's your goal. Do you think it's a proper goal?

Mr. **BRAGG**. No, I think we need to have a study to take a look at what the goals of the tax system are; and I don't think we have ever addressed that. I think it's something that we have to bring about. In other words, the tax laws do affect behavior.

Senator **BAUCUS**. Probably the codes are too complex.

Mr. **BRAGG**. Absolutely.

Senator **Baucus**. You, in effect, suggest that we have a bipartisan nonpolitical commission to study the questions for a sufficient period of time, analyze the economic impact and try to figure out what's really going on here, and then Congress should virtually adopt that.

Mr. **Bragg**. Your initial question was, what are those large goals that we are trying to establish with the system? One of them is simplification. That's the obvious goal; that's not the only goal. Therefore, the other goals are to stimulate the economy to help out the depressed areas. There is a multiplicity of goals there, but I think it should be approached by doing a study, first, instead of a patchwork of legislative changes in law.

We, frankly, are willing to trade for simplicity, but let's just take a study so we can at least analyze the changes that have taken place. If we go on like we have been, in my opinion, it will have an adverse result.

Mr. **Burke**. I think one concern, Senator, is it's been addressed here; but I think as we reflect on the tax legislation since 1981, so many of the provisions seem just regenerated in committee without much thought and then one begins considering the fundamental tax reform where we're going to have everybody in the country making themselves known.

The installment sales provision recording of recapture is a real trap. I see numerous provisions like that that I think is the tip of the iceberg if we get into that process.

Mr. **Sather**. The Treasury is proposing a limited cash method. That's been something in the Tax Code since it's inception.

Senator **Baucus**. That's part of the proposal.

Mr. **Sather**. Yes. They, basically, are saying that anybody who has reached $5 million and keeps books and records and anybody who has to borrow has to keep books and records on the accrual or has to have a financial statement so that, basically, would eliminate the cash method. Our tax returns are blatantly kind of doing this and I mean, you take a fundamental change and its impact and you're talking about the business that where a little CPA is doing business on a cash method and all of a sudden that's taking their money out and spending it wherever. It may take some people 6 years to get caught up and go back on an accrual method. That's just a frightening fundamental change. The whole concept is this. And then, they try to justify it in such a ludicrous way. They never once said that the real reason for the change is, we want to collect more money faster. They can at least be up-front about it.

Senator **Baucus**. I'm sure that is the only reason.

Mr. **Sather**. They don't say that. And, you know, these are the kinds of things that are hiding in the system and these are the kinds of things that I've seen.

Senator **Baucus**. That's a good point. In some respects, that's how the imputed interest rules were enacted. The Treasury put that in provision the bill and no one in the Congress caught it. The Joint Tax Committee didn't see it. Nobody saw it. The real estate lobbyists in Washington didn't see it until it was, virtually, enacted.

Mr. **Sather**. We were trying to get it in such a short period of time.

Senator **Baucus**. That's right.

Mr. **Sather**. We didn't bother to have input from some of the answers that might have been out there.

Senator **Baucus**. OK. Parting shots? Here is your last chance. OK. Thank you all very much. You've been a great help.

[Whereupon at 4 p.m., the committee recessed, to reconvene at the call of the Chair.]

[Additional information follows:]

Lake Milling, Inc. PHONE: 406-363-2334
110 MILL STREET HAMILTON, MONTANA 59840

Senator Lowell Weicker
Senate Office Building
Washington D.C. 20510

Dear Senator Weicker:

I apologize for not being able to attend your hearing for Small Business tax issues that was held in Missoula, but I am sure you understand the problems of a small, family operated, business. When situations arise that must be handled all else is put aside until it is solved, unfortunately, I was faced with that decision. I would have very much liked to attend the hearing because dialogue between the front line troops and the decision makers is always needed.

I appreciate your willingness to spend the time to search out input from the small business owners, and I hope that my comments will help in the process of establishing a new, fairer, tax system.

The proposed new tax-law probably will have some faults, but I urge you to resist the barrage of special interest groups that are going to plead their case to you. I am sure that many will tell you that the end of the world is near for them unless they are protected. I am afraid that the end is near unless we do something to change our current direction.

I would reiterate my plea to "please do something about our spending policies as well as our tax system", because there is a limit to what can be siphoned off a business and have the business survive!

I would welcome any questions or comments you may have concerning my testimony.

Sincerely,

Robert G. Lake

RGL:mm

TESTIMONY PRESENTED AT THE SMALL BUSINESS TAX HEARING IN MISSOULA, MT. MAY 28, 1985.

SENATOR BAUCUS:
SENATOR WEICKER:

I AM ROBERT LAKE. MY WIFE AND I OWN A SMALL FEED MANUFACTURING FARM SUPPLY BUSINESS IN HAMILTON, WHICH IS FIFTY MILES SOUTH OF MISSOULA. I AM CURRENTLY CHAIRMAN-ELECT OF THE MONTANA CHAMBER OF COMMERCE, AND HAVE SERVED AS THE CHAIRMAN OF THE SMALL BUSINESS COMMITTEE FOR THE PAST FOUR YEARS. I AM ALSO A MEMBER OF THE SMALL BUSINESS COUNCIL OF THE U.S. CHAMBER OF COMMERCE.

I APPRECIATE THE OPPORTUNITY TO APPEAR AT THIS HEARING. AFTER RECEIVING YOUR INVITATION I CONTACTED A GROUP OF MY BUSINESS ACQUAINTANCES FOR THEIR THOUGHTS. ALMOST, TO A MAN, THE REACTION WAS THAT BEFORE ANY TAX REFORM IS ENACTED WE NEED SPENDING REFORM. THE SMALL BUSINESSMAN OF MAIN STREET AMERICA CANNOT UNDERSTAND THE CONTINUAL INCREASE IN SPENDING WHEN OBVIOUSLY WE ARE OPERATING IN THE RED. EVEN WE, AS SMALL BUSINESSMEN, KNOW THAT WHEN THE BALANCE SHEET SHOWS RED, SOMETHING HAS TO BE CUT FROM THE EXPENDITURE COLUMN. IT IS DOUBLY HARD FOR US TO SEE THE GOVERNMENT WORKERS, EVEN THOUGH NO MORE EFFICIENT OR PRODUCTIVE, CONTINUE TO RECEIVE ANNUAL WAGE INCREASES WHEN OUR EMPLOYEES HAVE BEEN FORCED TO GET BY WITHOUT. ONE OTHER COMMENT WAS THAT TAX REFORM IS A NOBLE IDEA, HOWEVER, THEY FEARED THAT IT WOULD BE NOTHING MORE THAN THE RENAMING OF THE MONSTER, AND BECAUSE SMALL BUSINESS IS THE BOTTOM OF THE TOTEM POLE IN LOBBYING EFFORTS, WE WILL END UP AS THE FIRST PAWN TO BE SACRIFICED. EVERYONE WANTS TO SEE REFORM BUT NO INCREASE IN TOTAL TAXES.

SENATORS, PLEASE REMEMBER THAT SMALL BUSINESS IS THE BACKBONE OF AMERICA, PROVIDING IN EXCESS OF 90% OF THE PRESENT JOBS AND HAVING THE HIGHEST POTENTIAL FOR GROWTH IN EMPLOYMENT OF ANY EMPLOYER, AND THAT A STRONG, HIGH EMPLOYMENT RATE, IS WHAT PROVIDES THOSE TAX DOLLARS THAT PAY FOR THE PROGRAMS. IT IS UP TO YOU TO MANAGE OUR MONEY AS WE DO OUR BUSINESS, EFFICIENTLY WITHOUT WASTE.

NOW, SINCE I AM NEITHER AN ACCOUNTANT OR A LAWYER, MY ANSWERS AND REACTIONS TO YOUR QUESTIONS WILL BE BASICALLY MY OWN OPINIONS OR MY INTERPRETATION OF COMMENTS BY OTHERS. FIRST, IS THE CURRENT TAX CODE TOO COMPLICATED? I BELIEVE THAT IT COULD BE CLEARED UP AND BE BOTH FAIR AND SIMPLE. I ALSO FEEL THAT IT WILL NEVER HAPPEN BECAUSE THE SAME SPECIAL INTEREST GROUPS THAT INFLUENCED THE CHANGE IN THE

FIRST PLACE WILL BE THERE TO ASSURE THAT NOTHING WILL BE DONE TO REVERSE THE PRESENT SITUATION, AND IN FACT MOST WILL TRY TO INCREASE ANY ADVANTAGE OR TAX BREAK THEY ALREADY HAVE. MANY OF OUR CURRENT TAX CODES ARE THE RESULT OF AN ATTEMPT TO MANIPULATE THE ECONOMY AS CERTAIN SITUATIONS DEVELOPED, THEN AS THAT SITUATION CORRECTED ITSELF THE CODE WAS LEFT INTACT, AND PEOPLE BEING PEOPLE, ADJUSTED THEIR ACTIONS TO FIT THE CODE AND GIGANTIC LOOPHOLES WERE THE RESULT. I PERSONALLY WOULD LIKE TO SEE A "SUNSET CLAUSE" BUILT INTO ANY AND ALL REVISIONS TO THE BASIC TAX LAW. THE GOOD ONES WILL THEN BE RETAINED AND THE POOR WILL BE CULLED.

AS TO THE CORPORATE TAX RATE. MY FEELING IS THAT CORPORATIONS ARE OWNED BY PEOPLE AND PEOPLE SHOULD PAY TAXES, NOT THE THINGS THAT THEY OWN. IF CORPORATE DEDUCTION CODES WERE CHANGED TO LIMIT WHAT CAN BE CLAIMED, SUCH AS THE TAKE OVER OF A BUSINESS FOR ITSS TAX WRITE-OFF. ITS RETAINED EARNINGS WERE FIGURED AS A PERCENT OF TOTAL OPERATING REVENUE, WITH EVERYTHING ELSE DISTRIBUTED AS DIVIDENDS, WITH THE TAX WITHHELD THE NEED TO TAX CORPORATE PROFITS WOULD BE MET. IF CORPORATIONS PAY TAXES, THE COST IS SIMPLY ADDED TO THE SELLING PRICE AND OUR INFLATION IS FUELED EVEN MORE. WORSE YET, OUT DEFENSE CONTRACTORS ADD THE TAXES INTO THEIR COST AND AS A RESULT WE PAY EVEN MORE TO COVER OUR DEFENSE REQUIREMENTS. IT IS A VICIOUS CIRCLE.

CONCERNING TAXING EMPLOYEE BENEFITS. I FEEL THAT THE TAX BASE IS BROAD ENOUGH IF LOOPHOLES ARE CLOSED AND SPENDING IS CURTAILED. TO TAX HEALTH INSURANCE, AND THE ALREADY LIMITED GROUP LIFE INSURANCE, WILL FURTHER BURDEN THE ALREADY FINANCIALLY PINCHED AMERICAN WORKER. THERE ARE MANY OTHER SOURCES OF REVENUE THAT SHOULD BE ADDRESSED BEFORE THE HEALTH AND LIFE INSURANCE COVERAGE OUR WORKERS RECEIVE IS CONSIDERED.

I BELIEVE THAT TO TAX CAPITAL GAINS AT THE SAME RATE AS ORDINARY INCOME WOULD HAVE A SERIOUS IMPACT ON THE NATION. WITHOUT THE OPPORTUNITY OF REWARD FOR RISK, INVESTMENT CAPITAL WILL DRY UP AND COULD EVEN AFFECT THE DECISION WHETHER OR NOT TO PURCHASE A HOME. AS A SMALL BUSINESSMAN EVEN THE CURRENT RATE IS DIFFICULT TO ACCEPT. FOR EXAMPLE: WE PURCHASED, AT DISCOUNT, A FACILITY THAT HAD SEVERAL YEARS OF HEAVY LOSSES FOR THE PREVIOUS OWNER. THROUGH A LOT OF HARD WORK, AND I WOULD HOPE GOOD MANAGEMENT, WE HAVE BROUGHT IT UP TO A LEVEL WHERE IT IS WORTH CONSIDERABLY MORE THAN WE PAID. IF WE SOLD TODAY, OUR TAX LIABILITY WOULD BE CONSIDERABLE

EVEN THOUGH THE ONLY THING DIFFERENT WE WOULD BE SELLING WOULD BE OUR GOOD NAME AND PROVEN TRACK RECORD. AT TODAYS RATE, I'M NOT SURE I BELIEVE THAT UNCLE SAM REALLY HAS THAT MUCH "SWEAT TAX" COMING, BUT TO TAKE IT TO FULL RATE WITH WAGES WOULD BE GROSSLY UNFAIR AND WILL DEFINATELY INFLUENCE OTHER ENTREPRENEURS WHO PUT MORE THAN JUST MONEY INTO THEIR INVESTMENT.

I AGREE TOTALLY WITH THE INDUSTRIAL DEVELOPMENT BOND CHANGE. I RECOGNIZE THE NEED TO BOLSTER THE ECONOMY IN CERTAIN AREAS, BUT I CANNOT ACCEPT THE COMPETITIVE ADVANTAGE GIVEN TO A NEW BUSINESS BY VIRTUE OF LOWER INTEREST RATES OFFERED BY THE GOVERNMENT. AS A BUSINESSMAN, IF A PROJECT CANNOT MAKE IT WITHOUT GOVERNMENT HELP, THEN IT IS QUESTIONABLE WHETHER IT SHOULD BE STARTED AT ALL. I HAVE COME TO THE REALIZATION THAT A GOOD IDEA REMAINS A GOOD IDEA, AND CAPITAL CAN BE FOUND TO FINANCE THE INVESTMENT, WHEREAS A POOR IDEA WILL FAIL REGARDLESS OF HOW CHEAP INVESTMENT MONEY IS ACQUIRED. I REALLY BELIEVE THAT RISK CAPITAL FOR PRIVATE INVESTMENT SHOULD COME FROM THE PRIVATE SECTOR. TO ENCOURAGE GROWTH, INCENTIVES SHOULD BE USED RATHER THAN DIRECT PUBLIC FUNDS. I WOULD BE VERY UPSET TO THINK THAT MY TAX DOLLARS WERE BEING USED TO FINANCE A COMPETITOR WHEN I AM STRUGGLING TO MEET MY OBLIGATION AND I AM PAYING FULL RATE FOR MY CAPITAL. PUBLIC FUNDS SHOULD ONLY BE USED TO PROVIDE GOODS AND SERVICES TO THE PUBLIC WHEN PRIVATE CAPITAL IS NOT AVAILABLE, AND THEN ONLY FOR THE BENEFIT OF THE PUBLIC, I.E. MEDICAL, RECREATION AND EDUCATION.

IT WOULD BE HYPOCRITICAL OF ME TO STAND HERE TODAY AND SAY TAX EVERYONE BUT THE SMALL BUSINESSMAN; RATHER, THE SMALL BUSINESS OWNERS WHAT I TALKED WITH ARE ONLY ASKING FOR EQUALITY. EQUALITY OF TAXATION AND OPPORTUNITY WITHOUT PENALTY FOR SUCCESS. WE HAVE NO PROBLEM PAYING OUR FAIR SHARE, BUT FEEL THE CURRENT LAW HAS BEEN SO MANIPULATED BY SPECIAL INTEREST, EQUALITY HAS BEEN LOST.

TAXATION WAS DESIGNED TO COLLECT ONLY THOSE FUNDS NEEDED TO PROVIDE FOR THE ORDERLY GROWTH AND SECURITY OF OUR NATION, BUT WE HAVE FALLEN INTO THE TRAP THAT EVERYONE DESERVES A STANDARD OF LIVING AND A MULTITUDE OF SERVICES WHETHER THEY WORK FOR THEM OR NOT, AND THAT SOMEHOW WHAT MONEY IS RECEIVED FROM THE GOVERNMENT DOESN'T COST ANYTHING. IT IS AN ATTITUDE THAT WILL LEAD TO OUR RUIN. ABOVE ALL, OUR TAX SYSTEM SHOULD NOT BE DESIGNED TO DETER OUR FREE ENTERPRISE SYSTEM. IT IS WHAT HAS GOTTON US TO WHERE WE ARE TODAY. TAXES CAN ONLY COME FROM PROFITS AND PROFITS CAN ONLY BE REALIZED IN A FREE MARKET ORIENTED SOCIETY. WE MUST NOT DEVELOP A TAX SYSTEM THAT IS SUCH A BURDEN OR SO RESTRICTIVE THAT PRIVATE ENTERPRISE BECOMES DISCOURAGED.

IN CLOSING, I WOULD ASK THAT BEFORE TAX REFORM, PLEASE DO SOMETHING ABOUT SPENDING REFORM. FOR OUR GOVERNMENT TO BE SPENDING 25% OF OUR GROSS NATIONAL PRODUCT IS WRONG. FOR GOVERNMENT TO COMMIT THAT HIGH OF A PERCENTAGE CANNOT LEAD US ANYWHERE BUT TO FINANCIAL DISASTER.

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

WEDNESDAY, MAY 29, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Billings, MT.

The committee met, pursuant to notice, at 9 a.m., at the Northern Hotel, Billings, MT, Hon. Max Baucus (acting chairman of the committee) presiding.

Present: Senator Baucus.

Staff present: Tom Walsh, tax counsel; Michael W. Evans, legislative counsel; and Lawrence G. Dalsin, professional staff member.

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BAUCUS. This is a Small Business Committee hearing on the changes in corporate and individual income taxes proposed by the President, and particularly as they affect small business.

Montana is essentially a small business State. I know from experience that a good part of the deliberations in Washington, DC, in the next several months will focus on how the proposal affect individuals and big business. There probably will not be as much national focus on small business.

Over the years it's been my experience that somehow small business is not given quite the same attention as other groups. I thought, therefore, it very important that we have a series of small business hearings. That is, that we try to determine better how the proposals affect small business.

It was Plato in ancient Greece who said, "When there is income tax, the just man will pay more and the unjust less on the same amount of income."

Plato was a pretty smart man. I think those words are as applicable today as they were then, as once again Congress is reexamining Federal income tax laws and once against proposals for reform are in the air.

Tax laws obviously are too complicated. The Tax Code is a 2,000-page nightmare. Longer than the Bible, the Talmud, and the Koran all combined.

Tax regulations are five times longer. For example, the rules for the investment tax credit are 50 pages long. And as one Montanan wrote me, "When it requires several pages to explain how to determine your filing status, the laws are too complicated."

Tax laws aren't fair. Two people earning the same income rarely pay the same income tax. Deductions, credits exemptions, all encourage people to seek new ways to avoid payng their fair share of the tax burden.

And the most wealthy taxpayers who can hire experts to design elaborate tax shelters wind up holding a large share of the tax they should be paying. There's no question that the President and Congress need to dramatically overhall the Federal tax bill.

Yesterday President Reagan proposed a major overhaul. I welcome his proposal. I think it's important for the country to move, to get the Congress to very significantly simplify the Code, make the Code more fair, although fairness is somewhat in the eyes of the beholder, and also try to essentially develop more confidence in the Code.

I also applaud him for taking the difficult first step. I think that, in reviewing Treasury 1, he learned that there are a lot of difficult choices. And he has made those choices, at least as a first step.

I think we can convert his proposal, however, to a more solid tax reform bill when Congress works on it during these next months. And it is now that the real hard job begins. Today's hearing is the first of many, many hearings as we try to determine how the I's are dotted and how the T's are crossed in the proposals.

The Senate Finance Committee, of which I serve, will conduct 40 days of hearings at least. The House of Ways and Means Committee will do the same. And when these two commitees finish writing their tax bills they must be passed by both Houses of Congress. It's going to be a very, very difficult process.

Our goals are fairness, simplicity, and economic growth. Sometimes those three goals work in tandem together and parallel along the same lines.

But let's not kid ourselves. More often than not, each of those three goals work for cross purposes. Against each other. Simplicity often does not mean equity, or economic growth. And the more we pursue economic growth, often that runs counter to simplicity and equity.

So obviously we're going to have to make some very, very difficult, and in some cases, painful choices.

Today I want to focus on how all these proposals affect small business. I want to be sure that the tax reform is not a smoke screen for an increased tax burden on small business.

For example, I was quite astonished when the first Treasury proposal entirely abolished the graduated corporate income taxes and replaced them with the single corporate income tax of 33 percent, which would have meant the small business would have been paying a much greater portion of corporate tax burden. That obviously, though, has been changed in Treasury 2.

I also want to achieve practical simplicity, not some economist's theory about simplicity. I want to be sure that tax reform helps make your business decisions simpler so that you can spend more time dealing with how to produce a better product and less time trying to figure out how how to deal with the Tax Code.

Third, I'm particularly concerned about how tax reform will affect the bottom line in Montana's businesses. In recent years we have used the code to stimulate investment, spur productivity, strengthen business. All of this has made the Tax Code more complex.

But as we work to make the code less complex, let's make sure we don't throw the baby out with the bath water by eliminating incentives that work. We need reforms that will make us more competitive, not less.

These are some of the questions I hope to discuss today, and I again thank the witnesses who are here today to help us address these issues.

I will begin first with—I guess go down the line here. First, Conrad Fredericks from Big Timber. Connie, why don't you proceed.

STATEMENT OF CONRAD B. FREDERICKS, ATTORNEY-AT-LAW, BIG TIMBER, MT, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Fredericks**. Thank you, sir. I'm an attorney, and I'm primarily engaged in litigation and administrative law. I'm a member of the National Federation of Independent Business, as are a substantial number of businesses in my county.

All of the business in Sweetgrass County, including agriculture, is small business. In fact, it's considerably smaller than the maximum size in the Federal definition of small business.

I'm not a tax specialist, so I don't know the intricacies of the various proposals currently in existence. However, as a small businessman myself, and as a person who represents a number of small businesses, I believe that I have some insight into how, in general, certain parts of the various tax proposals will affect me and other small businessmen.

Senator Baucus sent a few sample questions of the sort confronting Congress in the coming months, and I'd like to address some of those questions.

The first question was, is the Tax Code too complicated now. As a lawyer, I believe that the Tax Code is too complicated for the average person or small businessman to understand.

I think the complicated nature of the Tax Code is demonstrated by the large number of regulations which have been promulgated by the Treasury Department attempting to interpret the enactments of Congress. It appears at times that the code enacted by Congress is so complicated that even the Treasury Department has difficulty in interpreting it and drafting their regulations. I think this is amply demonstrated by the confusion and uncertainty generated by the Tax Reform Act of 1984.

The second question is, should be have a single corporate rate or instead a low rate for small businesses and a higher rate for larger ones. In my opinion, we should have a lower rate for larger ones. In my opinion, we should have a lower rate for small businesses and a higher rate for larger ones. A flat corporate tax of 33 percent or 30 percent would effectively double taxes for hundreds of thousands of small businesses, including those in Montana. At the same time, this same flat tax would provide a substantial reduction in the taxes of some of the largest corporations.

I would like to commend Senator Baucus for introducing a resolution opposing the elimination of graduated corporate taxes.

Senator **Baucus**. Opposing the elimination.

Mr. **Fredericks**. That's what I said——

Senator **Baucus**. I'm sorry.

Mr. **Fredericks** [continuing]. Opposing the elimination of graduated corporate taxes.

The third question is, should we broaden the tax base by taxing employee benefits like health insurance and group term life insurance. I do not believe so. One of the ways a small business can afford additional compensation to its employees with tax benefits for both the employer and the employee is by furnishing these employee benefits to the employees. If these benefits are taxed, then the effective compensation of the employees will be reduced, making it more expensive for employers, and particularly small employers, to provide adequate compensation to their employees and compete with larger employees for the labor force.

In an area of small population such as ours, and with a depressed economy such as ours, it is difficult enough now for employers to keep and retain qualified employees and still keep the overhead down to the point where the business is still viable.

The next question is, should we tax all income the same, or tax income from capital (capital gains), at lower rates than income from labor.

In my opinion, income from capital should be taxed at lower rates than income from labor. In my opinion, it is capital, and the investment and risk of capital, that is the basis of all real income. I do not believe that the investment or risk of capital should be discouraged by taxing gains from long-term capital investment as ordinary income.

At the very least, if gains from long-term investment of capital are to be taxed as ordinary income, then the increase of the value of the capital which is caused by inflation should be indexed.

Another alternative which could have some merit would be to treat capital which is used to provide jobs, products, and services, either directly or indirectly, differently from other types of investments.

I believe that the accelerated cost recovery system should be retained, as well as optional expensing of a certain amount of depreciable business property. With many small businesses, such as are in our area, these tax advantages are the only thing that make it economicaly feasible for the business to be able to afford to purchase new business equipment.

Also, in certain professional businesses which use business equipment in which the technology is changing rapidly, some of the equipment becomes obsolete or functionally obsolete before it can be fully depreciated using longer methods.

For much the same reasons as outlined heretofore, I believe that the investment tax credit should also be retained as a vehicle for the very small business to be able to afford to purchase certain types of depreciable property.

From the standpoint of a personal taxpayer, from an area that sees substantial ups and downs in the local economy, I feel that the retention of income averaging is essential in order to smooth out the tax load in good and bad years.

In addition, from a personal standpoint, I feel that it is essential to retain deductions for both business and nonbusiness interest. Coming from a State with a low tax base, sparse population, and high cost of government per capita, I certainly feel that it is important to retain the deductions for State and local taxes, including income taxes.

Right now in our county our mill levy is right up to the limit, and our taxes, our personal property and real property taxes are right at the top.

In closing, on behalf of all small businessmen in my area, and particularly the farmers and ranchers, I would like to express our appreciation to Congress for repealing the recordkeeping requirements with regard to the use of automobiles and other items of personal property.

Thank you, Senator.

Senator BAUCUS. Thank you very much, Connie. Next, Senator Bruce Crippen, Yellowstone County Senator. Bruce.

STATEMENT OF BRUCE CRIPPEN, STATE SENATOR, YELLOWSTONE COUNTY, BILLINGS, MT

Mr. CRIPPEN. Mr. Chairman, Senator Baucus, for the record, my name is Bruce Crippen. I'm a small businessman and developer residing at 3015 Gregory Drive in Billings. I'm also a State senator representing District 45 in Yellowstone County. And want to thank you, Senator, for extending to me the opportunity to attend here and speak as a witness.

I would hope that the attendance out there in the audience is not indicative of the interest. And I'm sure that it isn't. This is just the start of a—what I hope is a great deal of interest inchanging our tax codes.

I'll try to be brief as much as I can, being a politician, and I'll try to avoid comments that Connie had mentioned.

Last night most of us here in this room had an opportunity to watch and listen to the President's proposal for a major revision of the Federal tax codes. And his focus, as I can see, in part was to: one, keep more money in our pockets as he stated; two, to help the small business and women; three, provide incentive to invest in helping the small businessmen and women, and to create additional wealth thereby; and four, create new jobs through additional investment.

I would applaud his efforts as well as the efforts of the Members of Congress in attempting to wrestle with the problem of our complex code.

My testimony will deal in part with the new proposals, and in part with the problems as I see as a small businessman working—doing business in Billings, that we have as a complex business socieity of today.

Throughout this I think we should keep in mind some of the comments President Reagan made last night about what he wants to do with the revision and the efforts that he's making to bring these incentives to the small businessman and woman.

I suppose, Mr. Chairman, that a major, if not one of the major factors affecting me as a developer and a small businessman—and I'm sure other small businessmen and women—is the uncertainty that we presently have in our Tax Code. The uncertainty of what will happen next.

When the Tax Code was first instituted way back in the early part of the century, every 20 years or so there would be a revision. And then after World War II, that became every 15 years or so. And then soon it was 10, then 5.

And now we have a situation where every year the businessman and woman is in a position where they have to look forward to a potential major revamping of our Tax Code. They really don't know where Congress is going to jump next. And it is that uncertainty that I feel plays a very detrimental role in the area of development—in my case as a developer in real estate—but providing—not knowing where Congress is going to go next. The uncertainty.

It also affects the availability of investment capital, especially equity capital. If you're looking at investors, and you're talking to them about some type of an investment, and you naturally have to get into a tax law, what the tax laws may be today, and how you're proposing something to them, may very well be entirely different 6 months from now, and the whole investment program presented is out the window. This situation just results in a bad economic situation, I think, for all parties involved.

I would submit to you and the Members of Congress that inconsistent and constantly changing tax policy on the Federal level—and I might also add, in the State level—is worse than no policy at all.

So what are the options then? Well, I mentioned this to a couple of my associates, and the answer I got from one was, "Do nothing, for very little at all." Well, we know that that's impractical, because for one, the Tax Code is a nightmare. As stated, it is complex. The regulations can't even keep up with the new laws that are enacted every year. And it's, of course, the regulations that we as businessmen and women really are bound by.

Politically it's unrealistic because there's a demand for a change. And I think that's becoming more and more evident. There's a demand for more equity in our tax laws. And I would submit to you that it is unequitable.

And then, of course, as legislators, we always like to have our finger in the pot and stir the pot every once in awhile and enact laws. And from that standpoint, I can't see any way that whether you're in Congress or you're in the State level that we'll be able to avoid dealing with the tax situation. So we have to change, as stated.

But in so doing, I think it's important to keep in mind that we have to be consistent with the policy that was set down, both by the President, and then as refined by the Congress. And I go back to what he said before. And then we should do that in a manner that is going to provide equity to all Americans in some form or another, if that is in fact really truly possible.

Then once it's done, my suggestion to you, Mr. Chairman, and members of Congress, is to stop. Do it and then stop. Pass the laws and then say, "We're not going to pass any more laws for a period of time." And that will avoid, as I—when I said before, is we have the—is the uncertainty of the law. And that is to me as much of a detriment as the taking away of certain tax incentives, or the lack of availability of capital, it's this uncertainty.

OK. Going on. Another factor that I've aluded to is the availability of capital. And other than the uncertainty, it's probably the key factor, to me as a businessman. Obviously one of the areas is the high cost of money. In recent years the private sector has been forced to compete for a definite amount of money with the public sector, with the Federal and local governments. And as a result, not only do we have deficit, and the Federal Government has got to make up for that deficit, but there's a competition in the money market and interest rates naturally go up.

And I can tell who's going to win the battle in that. It's certainly not the private sector. It's going to be the public sector.

As I stated also, on certain tax laws, it's a major deterrent the availability of capital, both debt and equity capital.

But one thing that we have as Montanans that we have to contend with is our locality. Montana is the most remote State in the contiguous 48 States. We have a small market to contend with, a small market as it relates to conventional sources of large amounts of capital.

An example would be real estate syndications. Most real estate syndications of the national type you don't see in Montana. You see some, but on a very small level. But we do not have the market that would entice real estate syndications on the national level to come into the State.

And the same thing is true with joint venture capital. Large insurance companies, or companies—development companies that do that type of operation, the joint venture, are hesitant to come into the State because we have such a small market.

The size of our investments are small. That is the dollar demand, the demand for the dollar amount is small. And many of your companies that provide capital, both either on an equity basis or on a credit basis, prefer investments of $5 to $10 million as a minimum.

So Mr. Chairman, I'm pointing these things out that essentially apply to the businessman and woman in Montana. And I think when you're revising the Tax Code, and you're looking at incentives—and we're going to get into incentives in 1 minute—these are things that you have to keep in mind as it pertains to this particular State. And, of course, I guess that's what I'm primarily concerned about.

I might also add, we've got another problem in our State that has nothing to do with Congress particularly, and that is we're a united business State. And I would hope that the efforts of the Governor and the legislature are going to turn this deception around.

All of this lands, Mr. Chairman, to the fact that Montana needs to keep as much incentive as possible to its investors, which are generally local in nature. And the tax codes should be drafted with that in mind, provide these incentives and to keep some incentives that we have on the books now available to local investors.

Let's get into various aspects of the code. And I'm sorry, I'm a little over my 5 minutes, but I see that there are some people who aren't here, so I'm going to go ahead and go into it.

The industrial revenue bonds, there's been a lot of talk about elimination of the industrial revenue bond. And I would commend Senator Baucus for the efforts that you did well over a year ago, when we almost lost that source of funding nationally, and which would have been, I think, a disaster to the State of Montana.

Industrial revenue bonds, as most of us all know here, are a major source of venture capital in Montana. An example would be, from my own standpoint, would be some of the businesses in the Rimrock Mall. The Penneys buildings was raised by industrial revenue bonds. The Homestead has a number of buildings, and will continue to have a number of buildings, the funding for which will come from industrial revenue bonds. The TransWestern Life complex downtown is largely financed by industrial revenue bonds. Just to name a few.

So you can see that it is important, not only to Billings, but I'm sure to the entire State of Montana.

OK. I gues the first thing I would look at is if you're going to eliminate them or drastically change them, I'd have to look at why they're so effective now. And of course, the obvious answer is, because we have high rates of interest.

And in our conventional areas of financing, industrial revenue bonds have a tendency to bring the interest down, because they're tax-free. And of course, that's a benefit to both the lender and to the borrower.

And I would say that if we are going to eliminate these bonds, then in the alternative, are we going to see a reduction in interest rates, and as such, more competitiveness in the market for the private sector for the availability of capital. And my answer to that would probably be yes, in the long run. But I don't think we're entirely dealing with the long run. And even then it would be a question mark whether that would be entirely true. So I would question if the result would be justified by eliminating industrial revenue bonds.

I would suggest in turn that if you're going to make some changes, if that's in the mill, that you restrict the amounts to some extent and may be some of the terms.

But I would urge Congress, Mr. Chairman, to keep the bonds available for private financing as well as for public financing.

One of the things that you could do in this area—and I'll just mention this and get off of it—is simplify the issuance of these bonds. I've had personal experience of being involved in a couple of these things, and I found it to be a nightmare of red tape and high cost, legal costs, underwriting costs, and all kinds of costs. And, you know, I swore after I did the last one, I'll never do another one. But I'll probably come back, because that's the source of funds that's available. So simplification could go a long way in the industrial revenue bond area.

Tax incentives. Again, I mention that it's very important that we have tax incentives for Montana investors. Because if we don't what will happen is the money that's available will be placed in the safest possible investment. Generally those are certificates of deposit and time deposits. And while those may in turn provide more capital available, I think the net result will be there will be less there, and if a greater portion of that money could be put in investments, that in turn creates new jobs, new wealth, and new opportunity as what the President indicated he wants to do last night in his message.

We need equity capital as well as debt capital. We need some of these special deductions that we'll get into.

Interest. While I commend the efforts to restrict some of the abuses that we've had on interest, I would hope that Congress would refrain from disallowing interest deduction on—in the private enterprise area.

If that is curtailed or greatly altered, it will, I think, essentially eliminate the small businessman, especially in the area—and woman—especially in the area of development.

Interest is always, of course, going to be in favor of the lender. And without the deductability, it will just be a benefit to the lender and the large companies that have capital and are not necessarily concerned with the interest—and I'll get into that in a minute.

Taxes, real estate taxes, State and local taxes, I know that that's a proposal to eliminate those. I would submit to you, Senator, that they are actual, and a very real cost of doing business. Just like in anything else. And we allow deductions for various business expenses, and taxes are an expense. They're an out-of-pocket expense and have to be paid.

And this is especially true, as Conrad pointed out, in Montana, because we are a high property and income tax State. Maybe one of these days we'll have another alternative form of tax, such as a sales tax, but right not we don't. And to eliminate that deduction is going to be detrimental, as I see it, to the Montana businessman and woman.

I know others will testify on depreciation, and my one comment that I would have there: Let's be consistent with what we have. Let's not make next year—come up with a newfangled approach on depreciation to get at a very small segment of society, and maybe taking advantage to them. If you're going to do anything, I would suggest that you shorten the writeoff period and maybe stick with the more conventional straight line and a couple other types of depreciation.

Capital gains—and I'm just going through some of the list. And if you want me to stop, just raise your hand.

Senator BAUCUS. Let's go about 2 more minutes.

Mr. CRIPPEN. OK. That's about all I've got. You know, I don't know what is in store for capital gains. I know the President said last night, I heard that there's some rumor to the effect that they may be dealing with just the securities. I hope that's not the case. I think capital gains should—are a very necessary incentive. All capital gains are really as a deferral of your profits to one point in time, and rather than have them taxed at an oridinary income tax rates at a larger amount of profit, they should be taxed at a lower rate. Otherwise there's going to be absolutely no incentive from tax standpoint to deal in property—or invest in property that would result in capital gains. And I think it should deal in all types of capital assets, including real estate.

I would suggest, however, if you're going to do anything, you extend the time factor and make capital gains apply to long-term investment and not short-term speculation.

Finally, I guess I would say I would hope that you'd have some type of grandfather clauses involved. Because if you don't, what you're going to end up doing is screwing up investment that is based on the present tax laws, or tax laws we've had in the past, and I think you're just going to create havoc.

Now, I know you can't have an entire grandfather clause, but I think this is something that should be considered. And I'm sure it would be.

And in conclusion, I will say that, you know, we all agree that we need a good comprehensive Tax Code. And this is especially true for the small businessman and woman, and that's why we're here today. For without it, without some of these incentives, what you will have will be your large, wealthy corporations—and we need those corporations. I'm not knocking them, because they are the trend setters and pace setters, in my business especially. What you will have will just be those people, those individuals and those companies will have the wealth or the availability, the capital, and they will be the ones that will be doing their investing. And I submit to you that they won't be doing it in Montana. And you'll exclude the small businessman and woman. You've got to make the capital available to them. Otherwise it will only be the wealthy that will be building President Reagan's mousetrap that he alluded to the other night.

Sorry for going on, but I took you other guys' times.

Senator BAUCUS. Thank you very much.

I think Bruce made a very good point. You opened up by saying all this uncertainty, in many cases, cause problems.

In the last decade, Congress has changed the Tax Code dramatically almost every year. We passed a major rewrite of the tax laws, and then came along a couple years later and undid a lot of what we did. And obviously that uncertainty makes it very, very difficult for anyone, particularly business, to plan. There's nothing worse than uncertainty. People want to know at least what they're dealing with so they can plan around it or over it or under it, whatever. At least they want to know what they're dealing with.

It's particularly true with small business, because a good number of small businesses operate on a narrow margin. So it's even more imperative that the small businessman knows what he or she is dealing with so that he or she can operate at a profit.

It was suggested yesterday in Missoula that we just go back and repeal everything we did in the last tax law and just leave it at that, not yet into all this monkey business of trying to rewrite the whole Tax Code.

I personally believe that the country should make an effort in this Congress to make the code more simple. I firmly believe that there's too much cynicism in the country with respect to our Tax Code. There's just too many people that feel it's too unfair, it's too complex, and something's got to be done. So I think something does have to be done.

We should get rid of a lot of the tax expenditures. They total about $400 billion, by the way. And we should try to restore more equity.

But then after we do that, I think we should lock up the Senate Finance Committee hearing room and the House of Ways and Means hearing room, and throw away the key for about 5 years. Just make them storage rooms or something. But the point is, let's make sure that Congress doesn't come back and do this all over again.

But if we—if that is the course we take, it is imperative that this reform effort be a deliberative effort. That is, we have to find out what the fine print is all about. How the I's are dotted or the T's crossed.

As much as I applaud the President's proposal last night, it was pretty skimpy on details. We really don't know how all this is going to actually work out.

And there's a second and third level of ramifications here, too. We all know from the surface what it is, but it takes a little while to figure out what the second and third level is going to be.

In addition to all that, the Treasury Department, to my astonishment, did not run any kind of an economic analysis of the proposals at all.

I asked the Treasury Department when they came out with their first proposal, "Well, how is this going to affect the Amercian competitive position with other countries?" They had no answer. They didn't even think of that. Not only did they not study that, they did not even think of it.

And I suspect that Treasury 2 also paid virtually no attention to that as well. They paid no attention to the U.S. competitive position. And I'm sure thay paid virtually no attention to lots of other economic ramifications that apply in our American economy as well.

So I guess what I'm saying, Bruce, is that Congress changes the Tax Code way too often. But we have to do something in this Congress. And I think we should, therefore, make sure it's solid so that we're not tempted to come back and undo what we've done.

Let me focus on some specific issues.

Conrad, your emphasis on growth in keeping a lot of the President's provisions of the code which help stimulate business, as we talked about, income averaging, and State deduction, and fringes, and so forth; the question is—it's a very basic fundamental one, namely, is it worth trying to peel back some of these deductions and exemptions in order to broaden the base and get lower rates, or is it not? Is it more important to keep some of the social objectives that are in the code, or is it more important to have a more level playing field, more neutrality, and get lower rates so that more Americans can do whatever they want to do and spend less time thinking about the Tax Code?

Mr. **Fredericks**. Well, I think what your goal is in your tax—in your Tax Code, if your goal is to promote certain aspects of the economy and your goal is to encourage capital investment and encourage business, and which I mentioned in my testimony, I think capital in business really is the basis of all real income.

I think then you should leave some of these things and do promote that kind of thing. If your goal is just to make everthing simple as the dickens, regardless of the ramifications, then I guess you——

Senator BAUCUS. But for you, the goal should be more growth?

Mr. FREDERICKS. I think so.

Senator BAUCUS. And less simplification?

Mr. FREDERICKS. Well, I think certainly there's some room for simplification, because as you mentioned, your investment credit regulations, they're 50 pages. I certainly think that Congress and Treasury could somehow simplify things without, as you say, throwing out the baby with the bath.

Senator BAUCUS. Bruce, do you think it's worth the effort to get rid of a lot of these——

Mr. CRIPPEN. Well, again, I think you have to keep in mind what you're trying to accomplish. Now, if you want to end up with a simplistic tax bill, and that's your major goal—and that is not, by the way, what I would glean from what you have said at this point and from what the President said last night—then yeah, do that.

But the problem is, and I tried to point it out, you know, quickly in my testimony, was the fact of how is it going to affect us in Montana?

You know, the large companies and individuals, which are fine, have availability of cash. And I guess that's my main——

Senator BAUCUS. Large companies what?

Mr. CRIPPEN. Have availability of cash, be it equity, or capital debt cash. You know, I've seen that. And that's fine, you know. I don't. I have to go out in the marketplace and get it. I either have to go out to some lending institution and find it, or I have to go out to some individuals or other companies and say, "Would you invest in this project or that?" So I'm immediately at somewhat of a disadvantage.

You know, and I don't want to see anything that's essentially in the name of simplification, say, "OK, we're going to simplify this, we're going to eliminate, or greatly curtail the interest deduction," for example. Or taxes. Because the large companies have the staying power. And they can handle that. Because in the long run, their return on their investment that they have will take care of it.

But the small business man and woman does not have the staying power and cannot handle it. Primarily because most of that capital is limited to the nature of its equity capital. And it has to provide some income return immediately; or, two, if it's debt capital, credit capital, there's interest on it, and it has to be paid, and you have to have sources of income.

There's always going to be somebody, Senator, that will have the availability of a deduction and somebody else over here that doesn't. And I'll submit, that isn't bad.

Senator BAUCUS. OK. Let me be more specific. What is it that you think is in the present proposal that you think is detrimental to a Montana businessman's ability to raise capital? What have you heard?

Mr. CRIPPEN. Your're assuming I understand the proposal. And I'm not really that sure.

Senator BAUCUS. Just what you know.

Mr. CRIPPEN. And I didn't get much out of it last night. And, you know, I went through some of the proposals here, and you've got a multitude of different proposals. And I can just glean out of here from what I see.

Senator BAUCUS. Let me just tell you what little I know about it. First of all, the effective capital gains rate is lowered to 17½ percent. Because ever though only 50 percent is excluded, the top individual rate is down to 35 percent.

Mr. CRIPPEN. Does that apply to all—excuse me for interrupting, Senator—but apply to all capital assets?

Senator BAUCUS. That's the question. Nobody seems to know the answer to that question yet.

Mr. CRIPPEN. Bacause I was under the impression that Mr. Reagan had indicated that he was applying it only to securities. And if he does, then that's——

Senator BAUCUS. No, that's not——

Mr. CRIPPEN. That's not——

Senator BAUCUS. Nobody knows the precise details yet.

Mr. CRIPPEN. If some of it applies to all, then that's fine. Then I say yes, I would say keep it. Don't make it gains as ordinary income, because it really is not ordinary income.

Senator BAUCUS. I don't think there's any worry about that. I don't think Congress is going to eliminate favorable capital gains treatment.

But what about the investment tax credit? Is that important?

Mr. CRIPPEN. Well, in my business, it's—we don't get into that very much. But yes, I think someone like Tom Reed in his business, it would be far more important to him because he deals with larger capital expenditures than perhaps I would qualify for.

I think it's probably more important in a more industrialized community in a State than it would be in Montana. But I cannot—speaking just for myself, in the business that I'm in—and I would suggest you ask some of the—if there are any out there, that are in—that utilize that.

Senator BAUCUS. Sure. The interest deduction limitation applies more to individuals than it does to businesses.

Mr. CRIPPEN. See, we've heard all sorts of rumors, and nobody really knows.

Senator BAUCUS. That's a problem. But I'm trying to get at what you think, from a Montana businessman's point of view, is most important, and what you would like to see changed to make the proposal better yet.

Mr. CRIPPEN. Do we have until the end of the week?

Senator BAUCUS. Well, name two or three.

Mr. CRIPPEN. Well, you know, No. 1, depreciation is very important to a developer, because it's a source of cash. And again, it's a source of deduction. So it is a source of cash.

I would like to see the depreciation deduction kept. As I stated, if you're going to make any changes at all, I would—I prefer straight line, because I've been caught in that trap before down the line and I'm not going to do that. I keep with a couple of the traditioal methods, straight line, or one of the others.

And of course, if I had my druthers, I'd like to see the amount reduced rather than—if you're going to use it for an incentive, then reduce the amount of years involved. And of course, that would make the deduction larger. But I think that's important to keep depreciation.

The President referred to local taxes, you know. I think to—for me as a businessman, we pay large amounts of taxes. You know, several hundreds of thousands of dollars in taxes. These are cash items. They're not a bookkeeping entry. They're a cash item. And as I say, they're a cost of doing business.

And so I don't think the President quite understands what he's talking about when he wants to eliminate those, unless they're eliminated just in a personal area and not in the business sense.

But I didn't get that last night at all. And from what I've read, it would be a total elimination of those deductions. And I think that's wrong. That's another area.

Industrial revenue bonds are, I think—I don't like them, because they're extremely difficult—they were for me, at least—to become involved in. They're extremely complex—far too complex. When you're through with them, you have a book about that thick [indicating] for a $3 or $4 million issuance. They're far to complex and they should be simplified.

But I think you would be making a grave mistake for Montana in the elimination of that form of financing, because that's probably one of the basic forms that we have. You know, I could count the bankers here, and you'd be talking to them. It's very important. And if we don't have that, I don't foresee anything else coming in.

You know, I'm—you know, we could visit all day long, and I'll admit, some of these areas I'm not that particularly knowledgeable in.

The corporate tax rate. I'm not a corporation. But I have a tendency to agree with you, if you have one corporate tax rate, it's going to benefit the large corporations and not the smaller ones. And I don't think that that's the way we should go about doing it.

Senator BAUCUS. Let me read what I think is in the proposal with respect to the State and local taxes. I'll read from the proposal.

Mr. CRIPPEN. Is that one or two?

Senator BAUCUS. This is two.

Mr. CRIPPEN. OK.

[Discussion off the record.]

Senator BAUCUS. I'm sorry, I misspoke. I thought this was Treasury 2. This is only Treasury 1. Within Treasury 1, "The itemized deduction for State and local income taxes and other taxes that are not incurred in carrying on a trade or business or income-producing activity could be phased out over a 2-year period."

And that has not been changed in Treasury 2.

Mr. CRIPPEN. So it will be that are not business deductions.

Senator BAUCUS. That's right. Interest incurred in carrying on a trade or business remains deductible.

Mr. CRIPPEN. Is a trade or business—is an investment considered a trade or business?

Senator BAUCUS. I can't answer that question.

Mr. CRIPPEN. See, you know, what is——

Senator BAUCUS. But anyway——

Mr. **Crippen**. I go back to my master's in tax law of 30 years ago, and I know there's a difference between a trade or business and income therefore from an investment. And as you well know, there could be a very subtle distinction.

Senator **Baucus**. We'll have to look closely to see how it's applied.

Mr. **Crippen**. Well, one more point that we didn't discuss, Senator, and as long as we're just talking about it; you know, I'm a little concerned about the restriction on charitable deductions. I don't know what it's going to be. And perhaps——

Senator **Baucus**. That's going to be present law.

Mr. **Crippen**. That's going to stay as it is?

Senator **Baucus**. It's my understanding that all the Treasury 1 restrictions are cast out, so the charitable deduction remains as under the present law.

Mr. **Crippen**. I think that's, again, important to Montana because of the charities that we have here and the limited sources of funds that they have available. And, you know, what's limited to one side is going to be limited to them.

Senator **Baucus**. Well, you raised good points, Bruce, from the Montana angle. And IDB's are a form of financing that may be more important to us in Montana than other parts of the country.

And not only in Billings. Gosh, I was very involved in making sure you get the IDB's available to finance, say, the Sheraton Hotel in Missoula. And the Kalispell mall. If it weren't for IDB's, that wouldn't be built.

The fundamental question is, how does all this affect Montana? In that respect, I'm going to set up a Montana advisory group to look at these proposals to see how they affect Montana compared to other States. It's going to take a little digging to accomplish this.

Mr. **Crippen**. I commend you for that. I think that's an excellent idea.

Senator **Baucus**. It's going to take a lot of work. Frankly, I'm hoping that Montana CPA firms, banks, and such will dedicate some time to look into this. Because it's going to take a lot of work. And I haven't got the wherewithal to do it all.

I have a couple other basic questions. One is more philosophical. It's interesting, a lot of the theory here seems to have changed lately. One impetus behind this proposal is the feeling that America's going to prosper more if Americans have lower individual rates so they can save a little more as a tradeoff for higher corporate rates.

The theory is that the higher corporate incidence of taxation can be passed on in the form of higher prices or whatever.

But at the same time there's an additional savings pools available because of lower individual rates. That's the theory.

And the evidence that supporters of this theory people point toward is that's what's going on in Japan, for example, or in Western Europe.

The opposite theory is that we should have a lower corporate burden, just a little bit higher than the individual burden.

And I'm just curious what you think

Mr. **Crippen**. I'll let Connie start this up.

Mr. **Fredericks**. Well, a lot of these things that we're talking about as far as business deductions, or tax incentives for business don't necessarily apply to corporations. And your smaller business sometimes, if it is a corporation, if it gets hit with a higher tax rate and it ends in an adverse competitive position against its competitors, which may be partnerships or business entities, taxless corporations, and they can't pass this on somewhere. I think in your bigger business, in your bigger corporations, yeah, tax General Motors——

Senator **Baucus**. Manufacturers.

Mr. **Fredericks** [continuing]. And American Motors and Ford and Chrysler all the same. Well, then their competitive position vis-a-vis each other really doesn't change because they each pass it on to the consumer.

But when you get down into the smaller businesses where you're competing with other businesses and are taxed differently, then I think you put those people at a disadvantage perhaps.

Senator **Baucus**. Bruce.

Mr. **Crippen**. Well, first off, I'd say that I prefer graduated corporate tax. I'm not a corporation and none of my businesses are not involved in corporations. I think we know better. And we're not big enough to do that.

And if the policy behind it it is to put the burden on the corporate taxpayer, that they in turn can spread out that increased tax over a period of time, that may well be fine. I think one of the problems that we've seen is we've seen the larger corporations—I don't know whether it was Exxon or somebody—who hasn't paid any taxes.

Now, my question is that, maybe they didn't pay any in 1984 or 1983, but did they pay some in 1982? Did they pay a large amount? I mean, if they've gone through the 3 years without paying any taxes at all because of the losses, then I guess you have to look at the losses.

Now, are these real losses? Are these losses occurred from investment in nonrelated areas, speculative type losses? Then you may have a problem.

But if they're losses, or the lack of taxable income because that corporation has invested in its own business in some way, and doesn't have to—and is taking some additional deductions, which I don't think would eliminate entirely the taxes, then that's something else again.

I think it's somewhat of a fallacy to say, however, that if we tax the larger corporations with more, that they in turn are going to pass it out—around. That may work well, as Conrad pointed out in your larger corporations. It will not, however, work well in the small, sparse area.

Senator **Baucus**. Well, the proposal would retain graduated corporate rates. So although as a practical matter it's a little bit more of a burden on small business, the proposal will keep the same break points—I guess 25,000, 50,000, 75,000, 100,000—that occur in present law. On the other hand, the slope will be a little less graduated than now, because the top rate will decline from 46 to 33 percent.

So comparatively it looks like small business might be paying a little bit more than it is in present law. But we're going to work on that.

But at least the Treasury Department came out and basically kept graduated rates for small business, because a lot of us in Congress say, "Hey, you can't just tax small business the same rate as a big business." It just won't work.

Mr. CRIPPEN. Senator Baucus, you know, it's easy to attack corporations. Everybody envisions a corporation as a personal entity over there. We both know that's not the case. A lot of us are involved in corporations, may own corporations, may be a corporation ourselves, and so we're not talking necessarily about the big ones.

I think what I'd like to see is some type of incentive for corporations, big and little, but primarily the larger ones, to reinvest profits. Because I think by reinvesting profits, if possible, as a constant way of reinvesting, you're going to increase our base and you'll have the so-called ripple effect. And the net result is going to be a higher gross national product, or whatever standard you want to use, whatever index you want to use, you know, and more wealth and essentially again more taxation, even on a smaller level.

Senator BAUCUS. I don't have time to go into all of this, but the question is, how do you encourage larger corporations to reinvest? It's a very complicated subject.

Mr. CRIPPEN. I understand. Does it create new jobs? Does it create———

Senator BAUCUS. I don't think it does, frankly.

Mr. CRIPPEN. If it doesn't create new jobs, that's one thing. But if it creates a new base, then that's something else. And that type of a—there should be some incentive for that type of———

Senator BAUCUS. Well, someone suggested we should repeal the Gloss-Steegell Act in part so that bankers can have an equity position in companies. Now the trouble is that a bank will let you go if you're not doing very well. But if the bank has an equity position they've got a vested interest.

That's what the Japanese do. And Japanese companies, therefore, have a much higher debt-equity ratio. But they've got a ready source of financing, internal financing. And there's more stability. Less takeover, friendly or unfriendly, and so forth. More of an effort into productivity and reinvestment, rather than effort into rearranging the financial statements, as I think we do too much in this country.

Anyway, that's a whole another subject. Thank you all very much.

Mr. CRIPPEN. Thank you very much, Senator.

Senator BAUCUS. Our next panel is an agricultural panel. Let's see, I don't know who all is here. Joe Cartmill, Bill Yager, and Jack, are you here?

[Replied yes.]

Senator BAUCUS. OK. Might as well go down the list here. Joe, why don't you go ahead.

STATEMENT OF JOE CARTMILL, CARTMILL'S INC., BILLINGS, MT

Mr. CARTMILL. OK. I'm Joe Cartmill, of Cartmill's Inc., farm equipment in Billings.

First of all, I like what I heard last night. I think we should all be behind the President, get at least most of what he laid out passed. The following are some of my thoughts as well as other business people that I've talked with lately. And I got some input from them.

I'm not a public speaker, and I'm not a tax expert, and I wouldn't infer that, but——

Senator BAUCUS. You're probably better qualified than all those others.

Mr. CARTMILL. Well, I do have some—I'd like to point out some things we've already covered.

But the Tax Code is too complicated. In my opinion, one of the things that keeps it complicated is the constant changing. I say leave it alone. Because as it's been covered, in the last 10 years how many times has this thing been changed? I visited with some CPA's in getting some ideas in what to bring to this meeting, I think that came out stronger than anything else.

Taxing employees benefits is just another burden on the already overtaxed wage earner. Leave it alone.

I think most people are content with the present depreciation system, once we understand it and learn to work with it. Leave it alone.

Once we get our farmers and other business people in our State earning a profit again, investment credit will again become important. Leave it alone.

Leaving interest deductible is also important to all business people and homeowners. I understand the homeowner thing is going to be left alone. And we can leave that alone.

Farmer's cash accounting is important to most. Leave that alone.

We need to "declaw," in my way of speaking, the IRS. In my opinion, they make tax regulations and set policy. To me, that's taxation without representation.

I think we've kind of left the tax thing to the tax experts. We've been involved enough in this thing, and I think the IRS has way too much power. We need to have that back in our Congress and places that it should be.

In a nutshell, I think most people would like to see the loopholes closed. Make the Tax Code simple, than leave it alone.

In addition to my text here, I'd like to express something else this morning. Something that bothers me some. That is overadjustment. We're talking about a lot of adjustments.

If I can go back and relate that to something. We see customers that buy our machinery. We get a phone call that say, "Man, we're in trouble out here. We can't get this thing going." And you go out there and they've adjusted every nut on it. And you've got to go back to a certain place and get them back on it.

And what scares me, frankly, is that we might overadjust and make ourselves more of a problem than what we've got. But I believe that's something else.

So to coin another phrase, what I just said, is be careful. That's basically what I've brought.

Senator BAUCUS. Thanks, Joe.

Jack.

STATEMENT OF JACK ASAY, REPRESENTING THE MONTANA CATTLE FEEDERS ASSOCIATION, BILLINGS, MT

Mr. ASAY. Thank you. I'm Jack Asay. I'm here representing the Montana Cattle Feeders Association. And we appreciate the opportunity to be able to participate in this discussion. The embarrassing part of it, we're probably going to learn more than we're going to impart.

We certainly do favor any simplification of the Tax Code. In the search for equitable taxation, we recognize the need for yielding to, as well as resisting, changes in the system.

What's good for one person is probably going to be opposed by another. What we think is imperative to our well-being is certainly not going to be to somebody else's. So it's not an easy problem to approach or solve.

We do recognize the need to survive in this very tough business that we're in if we are to continue to contribute to the system.

Factors in the existing rules which have been considered beneficial and are now vulnerable are capital gains, capital investment incentives. In our case, the payment of costs is also a factor. Payment of fees, for instance.

Investment tax credits are another incentive for people to become investors in our business. Cost recovery options. Various kinds. Depreciation, income averaging, and interest deductions. And deductions of State and local taxes certainly have a bearing on what our bottom line is going to be.

The pursuit of our collective best interests includes consideration of national survival and individual business survival. The effects of proposed changes on individual survival may very well depend on the—more than just the procedures that are adopted, but the timing. If some of these things have been proposed to be removed, should be removed, the removal of some of them at this time would be pretty tough. In this particular business the—we're already, as everyone knows, in agriculture, in pretty tough shape. This is a very poor time to make changes which are going to change the rules and reduce further our opportunity to acquire funds and customers.

So the timing is just as important to us, I guess, as whatever is adopted as procedure.

At this time the most awkward part of it all is the fact that we don't really know what to expect. I guess everybody here was waiting for last night's Presidential tax message to get a clue. We didn't get anything very concrete. So we don't know much more than we did yesterday.

But I guess what it amounts to is the specific recommendations still remain to be developed and we need more knowledge about those recommendations.

I guess a couple of thoughts with regard to taxes and tax laws. The first part of it, I think our problem sometimes is not so much the taxes that we pay as the results of it because the most burdensome results are the employees it seems to generate. Sometimes I think we could get along with the rules if we could just get rid of the overabundance of people that enforce them. It's pretty hard to live with, whether it's in the area of taxation or other Government administration.

Another observation that I have is that very often these IRS rules run counter to what is good management. And certainly in certain areas of agriculture, good husbandry, for instance, might have to yield to a bottom line which is influenced by whether or not to pursue certain of the avenues which are available as a result of IRS regulations. So in that case——

Senator BAUCUS. An example?

Mr. ASAY. Oh, for example, the application of capital gains in the livestock operation. There's times when good husbandry would indicate the logical way to go. But if you apply some of the rules and regulations for capital gains, you find you're better off than if you changed that whole proceeding. I'm sure it must apply to other businesses as well.

Senator BAUCUS. I'm sure it does.

Mr. ASAY. Anyway, we thank you for this opportunity, and we look forward to more.

Senator BAUCUS. OK. Thanks very much, Jack. Bill, go ahead. Good to see you, Bill.

STATEMENT OF BILL YAGER, FARMER, EDGAR, MT

Mr. YAGER. Good to see you. My name is Bill Yager. My wife and I have a small diversified farming operation out at Edgar, MT, where we raise beets, hogs, and corn. I'd like to offer any support I can for tax simplification.

I think the President did a good job last night explaining why it's important. And I think one of the most important things is that a lot of business decisions are biased by the Tax Code. And some people might think those biases are good, other people might not.

I think, in general, the simplification is going to be consistent with good economic policy. And before I get too carried away, I want to admit that in the 4 years we've been farming, we haven't paid any taxes. So you might think that we don't have any complaints about the tax system. But I've got several, and I want to get into those.

The first one, of course, is paperwork. We spent 40 or 50 hours last year trying to fill out 12 pages of Federal tax forms. And both my wife and I have college degress, but we had to get help to complete those forms.

The little guide that's supposed to give you help is 80 pages long. Most of it is completely ununderstandable. Remember, we're talking about a very small, simple business that had no tax liability. But it took 40 or 50 hours of paperwork.

One example of the complexity, I have some pigs out in the barnyard there that are being depreciated, and when those are sold, they'll be subject to the capital gains tax rate. And in the same pen are pigs that don't depreciate, and they'll probably be taxed at the ordinary income rate when they're sold.

No, to me those pigs look the same, they wallow in the same mud, they eat the same feed, they even smell the same, but to the IRS they're completly different critters.

The second compliant I have is the way the Tax Code sometimes encourages outside investment in agriculture that's detrimental to people that make their living off land. As I mentioned, we're in the pig business. There's a fellow named Sid Bass down in Texas. He's getting in the pig business, too. But he's spending $50 million and he's going to build a pig farm that will produce 350,000 hogs a year. That's twice as many as the State of Montana produces. And I'm pretty sure that Sid wouldn't go in the pig business if he couldn't use his investment in hog facilities to shelter some of his oil income.

But in the case of hog buildings, they can be depreciated over 5 years, and they're eligible for the investment tax credit. But most agriculture structures are the only buildings that get that kind of special treatment, and I think that's what go Sid in the pig businesses.

And I think in a business where there's already overproduction, that his investment hurt not only those of us who are in the business already, but hurt the rest of the country, because he could have invested that money in something that would have been more productive.

My third complaint is the way that the Tax Code causes nonproductive business decisions. And Jack alluded to this. An example I can give is that a lot of hog farmers sell breeding pigs after they've produced just one litter. Now, if you keep a sow for additional litters, she will be more—the older sow will be more productive. Generally she'll produce better pigs and more of them.

But Federal Tax Code gives the favorable capital gains treatment to the breeding animals, while the return from market animals is ordinary income.

So in order to convert ordinary income to capital gains, more farmers will sell the breeding animals as soon as they start producing. Their production goes down, but also their taxes. And so what you've got is the result of what's best for the farmer is probably not for the most productive way to go.

What are the answers? As I've said before, I think simplification is the answer. I think that the investment tax credit could be eliminatged, although it's a tax provision that we use a lot. And it's been important to us. But I think that you can eliminate that and make up for it is accelerated deprection.

I think that very often the distinction between capital gains income and ordinary income is quite artificial and unnecessary. I don't understand why a tax market profit should be taxed differently if the stock was held for under 6 months or over 6 months. And I've already mentioned how that distinction, the capital gains distinction screws up the hog business.

So, I would think that Congress should consider eliminating preferential treatment of capital gains. I think you're going to have some problems, especially in real estate, if you don't index the basis.

But I think if you did that, that you could eliminate capital gains treatment. And I think that would be a great—at least in my business, it would be a tremendous step forward simplification.

I don't really know what the President has in mind for depreciation. I thought the ACRS was a great step forward when it started, and I'd like to see something like that retained.

I think accelerated depreciation is probably one of the strongest incentives for investment. And it's an unbiased—I think largely an unbiased incentive.

And I also like the option that we as small businesses have to write off capital investments as ordinary expenses, although we tend not to use that, because if we do write off those capital investments, we lose out on the investment tax credit. So as things stand, we tend not to use that option.

Senator, I know that some of these things I've advocated would, if taken alone, increase our tax liability, but I'm assuming that that increase would be offset by lower tax rates.

So I would close with just a couple of general comments. I want to emphasize again how important I think tax simplification is. I think it has to be done to restore the faith or the American people in the Government. And I think it has to be done to help us restore American productivity.

And finally, I just hope that Congress realizes that if you're going to have a Tax Code that's simple, fair, efficient, it can't also be a tool of social and economic policy. Every loophole that's in the law was put there for a good social or economic reason. I think you have to choose between simplicity and those social and economic goals.

I'd like to congratulate the committee for its interest in the tax reform, and I hope that they have positive results.

Senator Baucus. Thank you, Bill.

Bill.

STATEMENT OF BILL GILLIN, CHAIRMAN, NORTHERN PLAINS RESOURCE COUNCIL FAMILY FARM TASK FORCE, BILLINGS, MT

Mr. Gillin. My name is Bill Gillin, and I'm here this morning as a representative of the Northern Plains Resource Council.

Thank you, Senator Baucus, for the opportunity to present the viewpoint of our group on the proposed changes in Federal tax laws.

The Northern Plains Resource Council formed a family farm task force approximately 18 months ago and has since been studying in depth the factors leading up to the present crisis in agriculture.

The task force has been exploring possible actions and public policies that could restore agriculture to long-term health and assure the continuation of family-owned-and-operated farms and ranches that have proven so successful in the past.

The American people are the best fed people on Earth and at a lower percentage of their income than any other nation now or in past history. This should be adequate proof of the success of this system and the urgent need to preserve it.

We are seeing in the present crisis a very real danger of the family farm or ranch becoming a thing of the past and ownership and control of agricultural lands being concentrated in fewer and fewer hands with the dangers of monopolistic controls and the prospect of substantially higher food prices.

During our months of study we have found one common factor in alsmost all aspects of the present agricultural crisis, and that is the effect of Federal tax laws as applied to agriculture. These tax provisions that Congress has over many years put into the Federal Tax Codes in attempts to help agricultural people have all too often been used by High-income people for tax haven purposes, and the end result has been a drastic negative effect on the bona fide farmers and ranchers.

An excellent example of this in Montana is the sodbusting that has become so common in recent years. Most of the sodbusting has occurred in low-grade land with high potential for erosion. The grain from these operations is being dumped on an already overloaded market. The demand for rangeland for sodbusting has caused the price of these lands to inflate to totally unrealistic heights, making it impossible for young ranchers to compete in buying ranching units.

We are submitting with our written testimony a study prepared by Montana State University on the economics of sodbusting. This booklet will explain how the various tax loopholes and exemptions have been used to finance these operations and make them very lucrative for high income people.

Also included will be a list of the limited partnerships that have been involved in financing John Greytak's First Continental Corp. sodbusting. This particular group is responsible for plowing over half a million acres of grass, with the publicly announced intention of sodbusting over 1 million acres. This activity occurring largely as a result of tax policy leads us to believe the tax laws are in dire need of revision if there is any hope of restoring agriculture to long-term financial health.

The abuses of legitimate agricultural tax exemptions by outside investors and speculators has convinced us that the farm program and Federal tax revision should be considered together. The use of agriculture as a tax haven has contributed to the boom and bust cycles so detrimental to family-owned and operated units. It has fostered speculation in land and livestock that intensifies the collapses when they occur, as we are currently experiencing. Investors can buy in and out of agriculture. Family farms get wiped out and often are permanently lost from the agricultural industry.

These factors will persist without tax reform, regardless of how carefully Congress constructs a farm program aimed at keeping family farming operations paramount in America.

The limited partnerships and corporations that have become involved in agriculture in recent years are receiving an indirect subsidy from the Federal Government through tax writeoffs. They are by no means more efficient than the family-owned and operated units, but they have approximately a 2-to-1 advantage over the full-time operators because of these tax writeoffs.

Then, to penalize the full-time operator still more, these tax haven operators are dumping more and more commodities on an overloaded market, running up the price of land and machinery to unrealistic levels, creating erosion problems, pumping excessive amounts of water from some of the Nation's aquifers, even to the extent of depleting them, and putting long-time family-owned operators out of business.

All of this is being sponsored and encouraged by the present Tax Codes. These same tax haven operations have also been the recipients of billions in agriculture support payments, causing farm programs to be discredited in the eyes of the taxpaying public.

Tax policy has been a factor in transforming the livestock industry in recent years dramatically. According to the center for rural affairs, between 1980 and 1982, 30 percent of the pork producers in the United States left the business. Many of these were small- or medium-sized operations.

In the past years, six major corporations have announced expansions that will add nearly 1 million more hogs per year to U.S. production. In the hog industry, a 1-percent increase in supply creates a 2-percent decrease in price.

The effect of this increased production on an average producer who sells 1,000 hogs per year would be a loss of $2,400. This rapid industrialization of hog production has closely paralleled tax policies, including such breaks as the definition of certain livestock buildings as "equipment" for tax break purposes.

I'd like to just ad lib a bit here and go back to a point Mr. Yager made about Sid Bass with his $50 million hog factory. And this is all for tax writeoffs. And the question in my mind, how many young farmers, hog farmers, are going to get wiped out so he may enjoy a tax savings? That's a question that sticks in my mind.

The Congressional Joint Committee on Taxation recently estimated that farm tax shelters will cost the Federal Treasury $2.6 billion in revenue between 1985 and 1987. In these deficit-plagued times, this virtual hemorrhage needs to be stopped. Moreover, the deficit is no small contributor to problems of farmers faced with unprecedented high interest rates.

Specific tax provisions that foster off-farm investment in agriculture includes: Capital gains; investment tax credits; depreciation (especially accelerated cost recovery system); cash accounting; defining certain livestock buildings as equipment; deductions for interest; and deductions for land conversion from grass to grain or irrigated farming.

Many of these are legitimate deductions to the bona fide farmer or rancher operating under the current Tax Code, and are necessary under these circumstances.

If any or all of these provisions are deleted under the pending tax reform proposals, there must be a corresponding reduction in the overall tax rates so that these changes will not turn out to be punitive to present and future family farmers and ranchers.

For the time being we encourage the passage of legislation that would limit the amount of outside income that could be put into agriculture and thereby be exempt from Federal income tax.

We would recommend that this limitation be approximately equal to the national median income. This would allow a young couple getting started in agriculture to apply the income from one or both working off the farm to their agricultural enterprise without undue penalty.

Other short-term solutions can also be implemented, pending comprehensive tax reform, that would help deter tax sheltering in agriculture. We urge you to support legislation that specifcally addresses solutions to this serious problem.

Overall, we have arrived at the conclusion that the Federal tax system is seriously flawed and needs comprehensive reform if this country is to maximize its resources, labor, and management skills. The well-publicized inequities of the current system have substantially undermined taxpayers' confidence that they are being taxed fairly.

In conclusion, let me reiterate that we favor revision of the Federal Tax Codes, especially those provisions that are undermining family-owned and operated agriculture. The present system is tending to recreate in this country the feudal systems that plagued Europe for centuries and from which most of our ancestors fled when they came to America.

The feudal systems of Europe were protected by regiments of soldiers or knights in armor, while what we are seeing created in this country are feudal domains protected by regiments of accountants and tax lawyers.

Thank you, Senator.

Senator BAUCUS. Thanks very much, Bill.

[The attachments to Mr. Gillin's statement follows:]

ECONOMIC INCENTIVES FOR CONVERTING RANGELAND TO CROPLAND

by

Myles J. Watts, Lloyd D. Bender and James B. Johnson *

Introduction

Converting traditional grazing lands to cropland has aroused emotions in Montana and several other western states. Reasons for this conversion by farm and ranch managers and other investors vary from alternative enterprise profitability to speculation. Some farm and ranch managers may have expected a crop such as wheat to be more profitable than livestock, and converted rangeland to cropland. Some farm and ranch managers and other investors may expect benefits from current and future farm programs to increase net returns and the value of the new cropland. Additionally, investors in higher marginal income tax brackets may have benefited from selected Federal income tax provisions.

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* The authors are Assistant Professor of Farm and Ranch Management, Montana Agricultural Experiment Station, Montana State University; Economist, EDD, ERS, USDA stationed at Montana State University; and Farm Management Specialist, Montana Cooperative Extension Service, Montana State University, Bozeman, Montana; respectively.

This report evaluates how farm program and selected Federal tax provisions provide incentives for investors to convert rangeland to cropland for re-sale and to indicate the differing values of these provisions among investors. The economic impacts of an enhanced wheat price, as an indicator of the benefits of all farm program provisions, during the period the investor owns the land, and the economic impacts of capital gains, investment credit, accelerated depreciation, and depreciation recapture Federal income tax provisions are evaluated.

The Base Case

A hypothetical conversion of 2,000 acres of Eastern Montana rangeland, purchased for $100 per acre, to cropland over a five-year period is used to illustrate the effects of the farm program and tax provisions considered on the breakeven price for cropland. Breakeven prices are expressed in real terms (1983 dollars) with all tax provisions and the farm program in effect for a "base case". Then each major provision is suspended to illustrate the contributions of individual tax provisions and the farm program.

The breakeven prices indicate those prices (for different provisions in effect) that will make investors as well off as they were at the time of the initial investment. The sale of the cropland is assumed to occur after the investor has held it for five years. Sales prices could easily be considerably different from the breakeven prices. Sales prices above breakeven prices would result in additional capital gains. Under current capital gains provisions, the investor in the 50 percent marginal tax bracket would incur an additional tax liability of 20 percent of the difference between the sale price and the breakeven price (additional capital gains income multiplied by 40 percent subject to taxation, multiplied by the 50 percent marginal tax rate).

The hypothetical conversion is scheduled as follows:

Year 1 -- Rangeland is purchased the first year and the sod is turned in late summer.

Year 2 -- Fallow and land preparation activities are conducted prior to fall planting of winter wheat on the entire 2,000 acres.

Year 3 -- Weed control activities are conducted prior to harvest of the winter wheat crop of 13 bushels per acre. A tool bar cultivation is performed after harvest.

Year 4 -- Operations are identical to the second year.

Year 5 -- Operations are identical to the third year. The yield increases to 26 bushels per acre. The land is sold as cropland after the investor has held it for a full five years.

The Economic Model

The breakeven price of cropland is the price at which the net present value of all cash flows equals zero. The breakeven price includes the value of the all cash flows, including the tax benefits, such as capital gains, that investors would tie up until the re-sale at the end of year five. The breakeven price takes account of all operating costs, and includes interest charges and tax benefits of each year.

The breakeven prices in the following tables are presented in current (or time 1) dollars. First, net cash flow is calculated for each of the five years of the operation using the budgets and operations in Appendix Tables A-1, pages 22-23, and A-2, pages 24-25, and the value of any tax advantages for that year. Inflation is assumed to be 5 percent per year. Cash outflows in the first year include purchases of land and machinery, discing and tillage costs, and cash costs for real and personal property taxes. Cash inflows include the value of tax benefits from investment credit and the depreciation allowance. The net cash flow is negative in the first year. Fallow and planting costs result in a negative cash flow the second year. Cash flows the third year include inflows of cash from the sale of wheat and value of the tax benefits. Outflows cover such cash costs as harvesting, other field operations and real estate and personal property taxes. The fourth year is similar to the second year and also results in a negative cash flow. In the fifth year, the cash inflows include the land sale and sale of machinary, and wheat. Cash outflows include the capital gains tax, cash operating costs, and real estate and personal property tax.

The present value of each year's net cash flow is calculated by discounting at an assumed interest rate of 12 percent. Discounting incorporates the time value of money such that cash flows appearing at different points in time can be compared.

Provisions of Federal Income Tax That Apply to Rangeland Conversion

Several Federal income tax provisions apply to land conversion. Of these, capital gains and investment credit are the most important.

Capital Gains

Farmland sold after one year of ownership may qualify the seller to pay taxes on any profit (above the basis price) as capital gains. The maximum effective tax on capital gains is 20 percent, compared to an ordinary income tax rate that may be as high as 50 percent for Federal income taxes.[1] Therefore, the higher the ordinary income marginal tax rate, the greater the benefit treating income as capital gains.

The tax treatment of rangeland conversion costs contrasts with that of certain soil and water conservation improvement costs. Part of the costs of soil and water improvements (that above allowable amounts) must be added into the basis (acquisition price

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1. Income qualifying as capital gains is first reduced by 60 percent, then the remaining 40 percent is taxed as ordinary income. Thus, the effective tax on capital gains for a taxpayer in the 50 percent marginal tax bracket is 20 percent--40 percent of the capital gains income multiplied by the 50 percent ordinary income tax rate.

of land plus capital improvements) for calculating profits on land sales when the property is sold, and cannot be charged as an expense to reduce income taxes on current ordinary income.[2] In contrast, it is assumed that all of the rangeland conversion costs would qualify for deductions against current ordinary income, and would not affect the basis of the land.

Investment Credit

Farm machinery qualifies for an investment credit of 10 percent of the purchase price. The tax liability for the year the credit is taken is reduced by the amount of the investment credit. An investment credit of 10 percent on $10,000 reduces that year's taxes by $1,000.

Provisions of the Farm Program

The current Act allows for these offers to wheat producers:

1. A specified loan rate;
2. Deficiency payments expressed as the difference between target price and loan rate;
3. Diversion payments to compensate producers for a portion of their wheat bases put into conserving use;
4. Payments for storage; and

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[2] The allowable annual amounts and the practices that qualify vary.

5. Payments-in-kind to compensate producers for a portion of their wheat bases put into conserving uses.

The levels of each of these forms of compensation have varied from year to year.

To be eligible, the wheat producer must have established a wheat base. A wheat base could be established under the current Act according to specific criteria. The criterion applied varies from year to year, but was one of the following:

1. The base could be the acres planted the prior year;
2. The base could be the average of the wheat planted the two prior years; or
3. The base could be the higher of the prior year planted acreage, or the average of the two prior years.

The exact level of benefits that would accrue to a wheat producer with new cropland would depend on what year a base was established and which provisions of the program were elected.

In this analysis, a $0.50 per bushel higher wheat price is used as a proxy for all benefits a wheat producer with new cropland could have realized from farm program participation.

The Combined Value of These Selected Federal Tax Provisions to Investors Converting Rangeland to Cropland

The combined effect of the selected Federal income tax provisions is more valuable to investors in high marginal tax brackets than to those in low brackets (Table 1). [3] The breakeven price declines as marginal tax rates increase. Those facing a 50 percent marginal income tax rate can break even by selling their converted rangeland for $134 per acre. On the other hand, investors facing a 10 percent marginal tax rate must receive $192 per acre to break even. It is expected that investors facing the higher marginal tax rates are those who have found and will find the purchase, plowout and re-sale of converted rangeland most profitable.

The combined value of income tax provisions to investors at each marginal tax rate is the difference between the value at the zero tax rate ($219.06 per acre) and the value for each incremental tax rate--a difference of $84.92 for the investor at the 50 percent marginal tax rate who can break even by selling converted cropland for $134.14 per acre (Table 2). [4]

The advantages for the conversion of rangeland to cropland by investors could be passed on to farmers who buy the converted

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3. Rounded marginal tax rates are used throughout this report for purposes of comparison.

4. Subsequent analysis shows that background assumptions affect the level but not the pattern of these differences greatly.

Table 1: Breakeven Prices With Different Tax Provisions and at Different Tax Rates [a]

	Marginal tax rates [b]					
Tax provisions	0	10	20	30	40	50
	--dollars per acre--					
Base Case All 1983 tax provisions	219.06	192.00	177.01	162.39	148.11	134.14
Excluding:						
Capital gains	219.06	199.58	191.81	184.00	176.02	167.61
Investment credit	219.06	203.52	188.40	173.66	159.27	145.00

[a] See section "Provisions of Federal Income Tax That Apply to Rangeland Conversion" for definitions.
[b] Percentages of taxable income.

Table 2: Combined Value of the Selected Federal Tax Provisions at Different Marginal Income Tax Rates

Marginal tax rates [a]					
0	10	20	30	40	50
---dollars per acre difference---					
0	27.06	42.05	56.67	70.95	84.92

[a] Percentages of taxable income.

land. The farm manager who is taxed at a relatively low marginal tax rate, rather than purchasing and converting rangeland to expand a farm operation, might have less invested in cropland by buying cropland from an investor who can take advantage of the tax benefits. Investors who specialize in converting rangeland to cropland can take advantage of tax benefits. Profits from the sale of cropland are realized only if the investor can sell the converted cropland at a price above the breakeven price. The price that investors eventually get for converted cropland depends upon the supply of converted and other cropland and the demand for cropland.

Investors who purchased rangeland and converted it to cropland have contributed to the supply of cropland. How great the increase in cropland supply due to investors making use of farm program and income tax provisions is not known. Likewise, these investors' contribution to the increase in agricultural output, and the decrease in crop prices due to cropland expansion, is not known.

The Value of Capital Gains and Investment Credit Federal Income Tax Provisions

Capital Gains

If the sale of converted rangeland were excluded from capital gains treatment, it would have the effect of increasing the breakeven prices for investors at all nonzero marginal tax rates (Table 3). In the illustrative base case, the breakeven price after land conversion for taxpayers at the 50 percent marginal tax rate would be $167.61 if the capital gains treatment were not unavailable. Loss of capital gains treatment increases the breakeven price for the taxpayer in the 50 percent bracket by 25 percent.

Table 3: Value of Selected Federal Income Tax Provisions at Each Marginal Income Tax Rate

	Marginal tax rate [a]					
	0	10	20	30	40	50
	---dollars per acre---					
Capital gains	0	7.58	14.80	21.61	27.91	33.47
Investment credit	0	11.52	11.39	11.27	11.16	10.86

[a] Percentage of taxable income.

The value of the capital gains tax provision to investors at each marginal tax bracket is shown (Table 3). If the capital gains provision were to be altered, the breakeven prices for converted cropland would be higher--reducing the incentive for converting rangeland to cropland. The largest increases would occur at the higher marginal tax rates.

Investment Credit

The availability of investment credit to investors who convert rangeland to cropland is more important than might first be apparent. Investors who can take advantage of investment credit are those having tax liabilities from other income sources. The investment credit reduces these tax liabilities on a dollar-for-dollar basis. The investment credit provision allows a value equal to 10 percent of the investment in machinery and equipment in the first year of use to be used to directly offset tax liabilities on other income. [5]

Eliminating investment credit would increase the breakeven prices above the base case for all investors except those who have no tax liability against which to offset the credit. The value of the investment credit is essentially the same across all non-zero marginal tax rates (Table 3).

The Value of Farm Program Provisions

The farm program might have two possible effects on investors converting rangeland to cropland. The first could be increased revenues from the farm program during the period in which the investor owns the land. Payments for farm program participation take on several forms (diversion payments, deficiency payments, guaranteed loan rates, etc.). In this analysis, it is presumed the investors acquire a wheat base and that all farm program participation benefits during the five year conversion/ownership period are reflected in an enhanced product price.

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5. The equipment must be owned for a full five years in order to prevent a partial refund of the credit because of an early sale.

The base case assumes investors would benefit from farm program participation during the five year conversion and re-sale period. Program benefits are represented by an enhanced wheat price of $4.15 per bushel. Breakeven prices of the cropland for investors who benefit from farm program provisions are lower than those for investors who do not qualify for farm program benefits. Investors who received farm program benefits during the five year period do not need to receive as much for their cropland to break even (Table 4). The favorable effects of the farm program on cropland breakeven price vary by marginal income tax bracket.

Table 4: Breakeven Prices and Changes in Breakeven Prices Under Different Wheat Prices

	Marginal tax rates [a]					
Wheat price	0	10	20	30	40	50
	---dollars per acre---					
Wheat $4.15 per bu.	219.06	192.00	177.01	162.39	148.11	134.14
Wheat $3.65 per bu.	240.82	212.02	195.24	178.76	162.53	146.52
Change	+21.76	+20.02	+18.23	+16.37	+14.42	+12.38

[a] Percentage of taxable income.

The increase in breakeven price for cropland, due to an investor's ineligibility for farm program benefits or a decline in farm program benefits for eligible participants (shown as a lower per bushel price in this analysis) is greater for investors at the lower marginal income tax rates.

The second effect of farm programs on cropland prices is a higher selling price for cropland if the land is expected to qualify for future farm programs. The expected increased net returns would be reflected in increased selling prices.

Sensitivity of Cropland Breakeven Prices to Purchase Prices for Rangeland and Rangeland Conversion Costs

Breakeven prices are sensitive to the rangeland purchase prices and rangeland conversion costs. The sensitivity of the breakeven prices for cropland was illustrated by changing purchase price and conversion cost assumptions. The following assumptions were made:

> Rangeland prices were assumed to be $200 rather than $100 per acre.
>
> Conversion costs were assumed to be $23.91 per acre rather than $13.45 per acre.

The breakeven prices calculated under these assumptions are shown (Table 5).

Table 5: Breakeven Prices With Different Rangeland Prices and Conversion Costs, at Different Tax Rates

	Marginal tax rates [a]					
Background assumptions	0	10	20	30	40	50
			dollars per acre			
Base case	219.06	192.00	177.01	162.39	148.11	134.14
Rangeland price double	357.15	325.03	304.88	284.97	265.24	245.62
Conversion costs double	233.50	204.83	188.28	172.15	156.40	140.99

[a] Percentages of taxable income.

Possible Policy Options

The capital gains feature of the current Federal income tax provisions appears to be a major incentive for converting rangeland to cropland. The capital gains incentive is much greater for taxpayers at the higher marginal tax rates than for those at lower marginal rates. To realize capital gains, assets must be sold. Therefore, the capital gains feature provides greater incentives to those at higher marginal tax rates who are not going to retain cropland for production but who are going to take capital gains as soon as other tax advantages are dissipated. In order to expense conversion costs the first year, the investor must have a tax liability on ordinary income from other sources.

The capital gains and investment credit tax features outweigh the higher wheat price effect on breakeven prices for cropland for investors at the higher marginal tax rates (Table 6).

Table 6: Summary of Percentage Increases in Breakeven Prices for Converted Cropland Due to the Deletion of Selected Tax Provisions and Lower Wheat Prices

	Marginal tax rate [a]					
	0	10	20	30	40	50
	---percent increase---					
Capital gains	0	3.95	8.36	13.31	18.84	24.95
Investment credit	0	6.00	6.43	6.94	7.53	8.10
$3.65 per bu. wheat versus $4.15 wheat	9.93	10.42	10.30	10.05	9.74	9.23

[a] Percent of taxable income.

Various features of the current Federal income tax system could be altered to reduce the tax incentives for converting rangeland to cropland. Changes in existing provisions could be patterned after earlier tax provision changes that were made for similar reasons. Some of these include:

(1) The length of time that rangeland converted to cropland must be held before capital gains could be taken on the sale could be extended. That provision of the Federal income tax code currently applies to tree and fruit farms;[6]

(2) Converting rangeland to cropland may be defined simply as `treating earth' or `conditioning land to permit its use as farming land' under current tax regulations.[7] That change would prohibit the initial plowup costs from being deducted as an operating expense to effectively reduce the level of taxable ordinary income. Plowup costs would be considered preproduction expenses that have to be capitalized rather than expensed as is the rule for beginning pistachio tree farms.[8] Alternatively, the conversion costs could be treated similar to soil and water conservation measures that can be deducted as operating expenses over a period of years but in amounts not exceeding 25 percent of a taxpayers gross farm income in any one year.[9]

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6. See Code Sec. 278(a):Regs. PP1.278-1(a).

7. See Code Sec.182(c)(1);Regs. PP1.182-3(a).

8. See Regs. PP1.162-12.

9. Code Sec. 175(a).

(3) Allowing agricultural expenses to be used to offset income earned from other sources could be suspended. This could affect taxpayers with farming as the principal source of income but with outside sources of taxable income, and taxpayers whose principal source of income is elsewhere but who are purchasing rangeland for conversion to cropland and re-sale.

There are several bills currently before the U.S. Congress to limit the eligibility for farm program benefits. Senate Bill S.663, commonly referred to as the Armstrong Bill, is designed to prohibit the payment of certain agriculture incentives to persons who produce certain agricultural commodities on highly erodible land. [10]

In the Bill "highly erodible land" means land classified by the Soil Conservation Service of the U.S. Department of Agriculture as class IVe, VIe, VII or VIII under the Land Capability Classification System. Any person who produces an agricultural commodity on "highly erodible" land brought into crop production after the passage of this Bill would be ineligible for:

1. Any type of price support assistance for the commodity produced;
2. A loan for the construction or purchase of a facility for storage of such commodity;
3. Crop insurance for such commodity under the Federal Crop Insurance Act;

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10. S.663. 98th Congress, 1st Session.

4. Any disaster payments for such commodity; and
5. Any loan from the Farmers Home Administration.

Exempt from such restrictions under this Bill would be any agricultural commodity produced after enactment that was produced on newly-developed "highly erodible" cropland using a conservation system which had the approval of a soil conservation district, and which was based on the technical standards set forth in the Soil Conservation Service technical guide for the soil conservation district.

Summary

Federal tax provisions provide a major economic incentive for investors who do not plan to retain ownership of converted land to convert rangeland to cropland. Capital gains treatment of the increased value of converted cropland is the most important of the tax incentives evaluated followed by investment credit. [11] These two overshadow the value of other tax features to investors and the value of additional realized returns for wheat attributable to farm program provisions during the period the investor owns the new cropland.

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11. The costs of clearing land to make it suitable for farming is generally a capital expense. Included is conditioning "land to permit its use as farming land." (Code Sec. 182(c): Reg P 1, 182-3(a). We assume these provisions do not apply in this analysis.

The value of capital gains is greatest for investors in the higher marginal tax brackets. Capital gains benefits are captured only upon sale of land. Investment credit can be used only if matched against an existing Federal tax liability.

The farm program has two possible effects on the investor who converts rangeland to cropland. The first is increased revenue from farm program benefits during the period the investor owns the land. This analysis has shown that farm program benefits received by the investor during the investor's ownership period will reduce the breakeven price for cropland. These farm program benefits (measured as a higher wheat price) allow for greater reductions in the breakeven price for cropland by investors at the lower marginal tax rate than for investors at higher marginal tax rates. The second probable effect is a higher selling price for cropland if the land is expected to qualify for future farm program provisions. This effect was not estimated in this analysis.

APPENDIX A-Method of Illustrating the Value of Tax Provisions

A simulation of the conversion over a 5-year period of 2,000 acres of Eastern Montana rangeland to cropland is used to illustrate the benefits to investors from selected Federal tax provisions. Rangeland purchased in the first year is plowed out in the late summer.[12] The cost of the plowout in the first year is the operating costs of machinery (including labor) used in the conversion.[13]

The second year assumes fallowing and land preparation until winter wheat is seeded in the fall on all 2,000 acres. Only 13 bushels of wheat (half the historical average yield for the area) is assumed to be harvested the third year, after which the soil is cultivated once. Fallow operations in the fourth year are the same as the second year; winter wheat is planted in the fall. The wheat is harvested the fifth year and the soil cultivated once before sale of the land and machinery.[14]

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12. Operations budgets and total cash outlays for each year are presented in Appendix Tables 1 and 2, and machinery and equipment investments, repair costs, and used equipment salvage values are presented in Appendix Table 3.

13. Several definitions of plowout costs could be used. All costs incurred over the period of years needed to bring land into full productive capacity, including perhaps conservation practices, could be used, for instance.

14. A full five years of ownership qualifies the taxpayer for investment credit, without recapture, on farm machinery and equipment.

The Base Case

A "base case" is one standard of comparison for other results for which assumptions vary from the base case. The assumptions of the base case (other than the technical budgets and costs contained in Appendix Tables 1-3 and in tax codes [15]) are as follows:

Purchase price of rangeland	$100 per acre
Inflation rate	5 percent per year
Interest rate, nominal	12 percent per year
Depreciation (ACRS) rate	Tax Recovery Act of 1981
Depreciation recapture	Tax Recovery Act of 1981
Investment credit	Tax Recovery Act of 1981
Capital gains	40 % of ordinary tax rate
Wheat price	$4.15 per bushel
Wheat yield first crop	13 bushels per acre
Wheat yield second crop	26 bushels per acre

Breakeven Price

The results are presented as breakeven prices reported for each marginal tax bracket. The breakeven prices are expressed in real terms as if the sale were made by the investor in year 1 for delivery under contract at the end of year 5 at cost. Breakeven prices for cropland expressed in real terms adjusts for the fact that some funds for production costs are tied up for short periods of time while other funds for conversion and production costs are committed for longer periods and returns are received at various times during the five year period.

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15. See U. S. Department of Treasury, "Farmers Tax Guide" Publication 225 (Rev. Oct. 1982). Wash. D. C.:Internal Revenue Service.

Table A-1 : Annual Total Variable and Cash Fixed Costs
for the Years 1 through 5,
on a 2,000 Acre Plowup Operation in Eastern Montana

	Total	
		__Year 1__
	dol.	
Fuel	9,678	
Lube	1,452	
Repair	6,701	
Labor [a]	2,566	
Labor Overhead (20%)	513	
Real Estate Taxes	3,000	
Ins. Pers. Prop. Lisc.	3,000	
TOTAL YEAR 1	26,910	
		__Year 2__
Seed, 50 lbs./Ac.@.08	8,000	
Nitrogen, 16 Lbs./Ac.@.25	8,000	
Phosphate, 35 lbs./Ac.@.20	14,000	
Crop Insurance, @5.00/Ac.	10,000	
Fuel	10,934	
Lube	1,640	
Repair	6,667	
Labor [a]	3,151	
Labor Overhead (20%)	630	
Real Est. Taxes ($1.50/Ac.)	3,000	
Ins. Pers. Prop. Lisc.	3,000	
TOTAL YEAR 2	69,023	
		__Year 3__
Fuel	5,520	
Lube	828	
Repair	5,644	
Labor [a]	630	
Labor Overhead (20%)	126	
Spray, $3.75/Ac.cust.	7,500	
Harvest, $14/Ac.cust.	28,000	
Hauling, $0.01/bu./mi. over 5 mi.[b]	3,900	
Binning, $0.12/bu.cust.	3,120	
Real Est. Taxes ($1.50/Ac.)	3,000	
Ins. Pers. Prop. Lisc.	3,000	
TOTAL YEAR 3	61,269	

Table A-1: Annual Total Variable and Cash Fixed Costs
Years 1 through 5,
Continued

__Year 4__

Seed, 50 lbs./Ac.@.08	8,000
Nitrogen, 16 Lbs./Ac.@.25	8,000
Phosphate, 35 lbs./Ac.@.20	14,000
Crop Insurance, @5.00/Ac.	10,000
Fuel	10,934
Lube	1,640
Repair	6,667
Labor [a]	3,151
Labor Overhead (20%)	630
Real Est. Taxes ($1.50/Ac.)	3,000
Ins. Pers. Prop. Lisc.	3,000
TOTAL YEAR 4	69,023

__Year 5__

Fuel	5,520
Lube	828
Repair	5,644
Labor [a]	630
Labor Overhead (20%)	126
Spray, $3.75/Ac.cust.	7,500
Harvest, $14/Ac.cust.	28,000
Harvest, $0.12 over 20	1,440
Hauling, $0.01/mi./bu. over 5 mi. [b]	7,800
Binning, $0.12/bu.cust.	6,240
Real Est. Taxes ($1.50/Ac.)	3,000
Ins. Pers. Prop. Lisc.	3,000
TOTAL YEAR 5	69,729

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[a] Field hours less 200 @ $5.50/hr.
[b] Grain haul assumed to be 20 miles.

Table A-2: Field Operations, Years 1 through 5,
for Conversion of Rangeland to Cropland
on 2,000 Acres in Eastern Montana

Year and operation	Machine width	Field speed	Field efficiency	Acres covered	Total time
	ft.	mph	percent	per hour	hours
			__Year 1__		
Plowup Operation					
Disc in July	25.00	5.00	75.00	11.36	176
Disc in Aug	25.00	5.00	75.00	11.36	176
Cultivate in Sept.	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00			0	
Rod weeder (tandem)	36.00			0	
Total Field Time					467
SUMMARY					
Total Tractor Fuel, gal.			(gal./hr. 9.45)		4,409
Total Pickup Fuel, gal.			(@10 mi./gal., 20,000mi.)		2,000
Total Truck Fuel, gal.			(@6mi./gal/, 8,000 mi.)		1,333
Total Fuel Cost, dol.			(dol./gal.=$1.25)		9,678
Total Lube Cost, dol.			(fuel $x15 percent)		1,452
Total Fuel and Lube, dol.					11,130
			__Year 2__		
Fallow-Plant Operation					
Cultivate	36 00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder (tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder (tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder (tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder (tandem)	36.00				
Drill	36.00	5.00	80.00	17.45	115
Total Field Time					573
SUMMARY					
Total Tractor Fuel, gal.			(gal./hr. 9.45)		5,414
Total Pickup Fuel, gal.			(@10 mi./gal., 20,000mi.)		2,000
Total Truck Fuel, gal.			(@6mi./gal.,8,000mi.)		1,333
Total Fuel Cost, dol.			(dol./gal.=$1.25)		10,934
Total Lube Cost, dol.			(fuel $x15 percent)		1,640
Total Fuel and Lube, dol.					12,574

Table A-2: Field Operations, Years 1 through 5, Continued.

			__Year 3__		
Harvest Operation					
Spray-Custom					0
Harvest-Custom					0
Cultivate-Spike	36.00	5.00	80.00	17.45	115
Total Field Time					115
SUMMARY					
Total Tractor Fuel, gal.			(gal./hr. 9.45)		1,083
Total Pickup Fuel, gal.			(@10 mi./gal., 20,000mi.)		2,000
Total Truck Fuel, gal.			(@6mi./gal.,8,000mi.)		1,333
Total Fuel Cost, dol.			(dol./gal.=$1.25)		5,520
Total Lube Cost, dol.			(fuel $x15 percent)		828
Total Fuel and Lube, dol.					6,348
			__Year 4__		
Fallow-Plant Operation					
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder(tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder(tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder(tandem)	36.00				
Cultivate	36.00	5.00	80.00	17.45	115
Harrow (tandem)	36.00				
Rod weeder(tandem)	36.00				
Drill	36.00	5.00	80.00	17.45	115
Total Field Time					573
SUMMARY					
Total Tractor Fuel, gal.			(gal./hr. 9.45)		5,414
Total Pickup Fuel, gal.			(@10 mi./gal., 20,000mi.)		2,000
Total Truck Fuel, gal.			(@6mi./gal.,8,000mi.)		1,333
Total Fuel Cost, dol.			(dol./gal.=$1.25)		10,934
Total Lube Cost, dol.			(fuel $x15 percent)		1,640
Total Fuel and Lube, dol.					12,574
			__Year 5__		
Harvest Operation					
Spray-Custom					0
Harvest-Custom					0
Cultivate-Spike	36.00	5.00	80.00	17.45	115
Total Field Time					115
SUMMARY					
Total Tractor Fuel, gal.			(gal./hr. 9.45)		1,083
Total Pickup Fuel, gal.			(@10 mi./gal., 20,000mi.)		2,000
Total Truck Fuel, gal.			(@6mi./gal.,8,000 mi.)		1,333
Total Fuel Cost, dol.			(dol./gal.=$1.25)		5,520
Total Lube Cost, dol.			(fuel $x15 percent)		828
Total Fuel and Lube, dol.					6,348

Table A-3: Machinery Investment and Repair Schedule
Based on 2,000 Acre Wheat-Fallow Operation
Eastern Montana

Machine	New Cost	Repair Cost Factor	Annual Repair	Fixed Cost Factor	Annual Fixed Cost	Used Five-Yr. Value
	dol.	%list	dol.	%list	dol. [a]	dol.
Tractor, 4-WD, 175 HP, Diesel	73,900	4.50	3,326	10.40	7,686	33,120
Disc, 25Ft.	16,375	6.00	983	10.40	1,703	5,334
Cultivator, 36 Ft.	15,500	6.00	930	11.40	1,767	5,049
Harrow, 36 Ft.	2,050	0.20	4	11.40	234	668
Rod Weeder, 36 Ft.	2,375	6.00	143	11.60	276	774
Drill, 36 Ft.	25,650	3.70	949	11.60	2,975	8,355
Auger, 8 In. @1,000 bu./hr.	2,200	3.30	73	11.60	255	717
Truck, 2 1/2 Ton	19,000	3.20	608	11.60	2,204	6,189
Pickup, 1/2 Ton	12,000	5.90	708	11.60	1,392	3,909
TOTAL	169,050		7,722		18,491 [a]	64,114
SUMMARY OF REPAIR EXPENSES						
Year 1			6,701			
Year 2			6,667			
Year 3			5,644			
Year 4			6,667			
Year 5			5,644			

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[a] This is an accounting entry not used for income tax purposes. Tax depreciation is figured differently from this calculation.

Sources: See Delwin M. Stevens and Douglas E. Agee, Using Farm Machinery Efficiently," Wyoming Agr. Exp. Sta. Bul. B 482 R, May, 1979 for efficiency rates.

Used value functions are from AGRICULTURAL ENGINEERS YEARBOOK 1979, p. 253.

NORTHERN PLAINS RESOURCE COUNCIL

To: Family Farm Task Force.
From: Jeanne.
Date: May 29, 1984.

In 1981, nine limited partnerships sued John Greytak's First Continental Corporation of Billings for a total of $795,000 for crops not produced or sold. According to the Billings Gazette, in 1979 the partnerships had agreed to buy First Continental's expenses on some farming operations during 1980 for tax purposes. At harvest time, First Continental was to either buy the crop back or sell it for them. The agreement fell apart when the crops were below average.

The partnerships sued First Continental for $795,000 for the crops. First Continental argued the partnership owed it $621,000 for expenses. (See enclosed Gazette article.)

Let's look at who is involved in these lawsuits.

Those suing First Continental are listed below. All have their principal place of business in Whittier, California. John Hancock Mutual Life Insurance Company has liens on all land parcels involved, and is listed as the only lien holder.

Oakridge Land and Mineral Co., organized under the laws of California, contract with First Continental to farm 4,750 acres in Big Horn County;

Visalia Crop and Orchard No. 1, organized in California, 4,320 acres in Musselshell Co.;

Fairview Farm and Ranch, organized in Mississippi, 4,569 acres in Big Horn County;

Peaceful Valley Farms, organized in Virginia, 2,626 acres in Golden Valley County;

Vista Land and Farming Co., organized in California, 4,426 acres in Big Horn County;

Nick's Land and Cattle Co., organized in California, 4,119 acres in Musselshell County;

Beef Breeding Associates, organized in Virginia, 3,261 acres in Yellowstone County;

Angus Beef Partnership 1978, organized in Virginia, 3,744 acres in Musselshell County;

Shenandoah Valley Farms, organized in Virginia, 3,615 acres in Custer County;

[From the Billings Gazette, May 8, 1984]

EXCLUSION OF WITNESS LEADS TO SETTLEMENT

(By Lorna Thackeray)

A lawsuit involving John Greytak's First Continental Corporation and nine limited partnerships who entered into a deal with Greytak for the 1980 growing season was settled Monday after U.S. District Judge James Battin granted a motion to exclude one of the chief witnesses in the case.

Battin also granted judgment against some of the partnerships, agreeing with the contentions of First Continental that attorneys for the partnerships had not cooperated in getting the case moving.

The witness excluded by the judge was an accountant who was essential in establishing damages sought by the partnership. First Continental attorney Brent Cromley objected to the witness on the grounds that she was not made available for questions on her calculations until last Friday, the weekend before trial was scheduled to begin.

The case began with an agreement made in December of 1979 whereby the partnerships agreed to buy First Continental's expenses on some farming operations during 1980 for tax purposes.

At harvest time, First Continental was to either buy the crop back from them or to sell it for them.

But the crops were well below average that year because of drought, and the agreement fell apart.

The partnerships claimed the Billings firm owed them a total of $795,000 for the crop. First Continental argued that the partnerships owned it $621,000 for expenses not covered by the proceeds from the grain sale.

Terms of the settlement were not available Monday.

Greytak is best known in Montana for turning thousands of acres of rangeland into cropland in controversial sodbusting operations.

Senator Baucus. I think all of you somewhat touched on a point that's pretty sensitive, and that's the freedom with which someone should be able to shelter nonfarm income, say, with farm losses. I agree that's a problem. That's a severe problem.

I guess the first question that comes to my mind is whether today with the difficult plight agriculture is in, is it time to limit the availability of nonfarm income to be sheltered by, say, farm losses.

The concern is, if some limitations were enacted today, land values would start to fall. And that would hurt agriculture.

I'm just curious what your reaction is as to timing and how you would get at the problem. Some of you may think there should be no limitation whatsover, and if that's the case, I'd like to hear that as well.

Who wants to take a first crack at that?

Mr. Gillin. May I comment on that, Senator?

Senator Baucus. Sure.

Mr. Gillin. I think we're in a rut now, and all we've got left to do is climb out of it. Land prices have dropped in some places as much as 50 percent. And one thing we ran into——

Senator Baucus. You don't think they'd drop more?

Mr. Gillin. If they would drop another 50 percent, they'd still be overpriced in our area. As far as from a production standpoint, yes.

I'm not advocating dropping land prices. But we have gotten a completely unrealistic price on our lands. It has no more resemblance to productivity of the land. And I'm not advocating or wanting to see it happen. But I think we've got to get out of this rut and—what's the term—bite the bullet. I know that's not going to be a bit popular.

Senator Baucus. Jack, what do you think about it?

Mr. Asay. We've heard recently all of these reasons that agriculture is a problem. This is one we never hear talked about. I think probably because there are many nonfarm investors. It's going to affect the net worth of everybody, whether they're farming land or own it somewhere else. But this is the one biggest problem that there is.

Just for example, when you apply a high interest rate against a ridiculously high land value, then you can't pay the interest on the land. I guess when ranch prices got to $3,000 per animal unit, is when it really showed.

Senator Baucus. Do you think there should be any limitation on outside investors' availability to shelter their income with farm losses or set off nonfarm income against farm income or loss? Should there be any limitations whatsoever, or should there not?

It's a difficult question, because once you start down that road, you open the door as to what kinds of losses and income can be offset against other kinds of losses and income. It also makes the code more complex.

Mr. Asay. I don't have a simple solution.

Senator Baucus. So I'm just curious as to where each of the four of you think we should draw the line?

Mr. Asay. Well, this is the problem as far as I'm concerned.

Senator BAUCUS. What's the problem?

Mr. ASAY. This business of inflated land.

Senator BAUCUS. OK.

Mr. ASAY. Way beyond its capabilities.

Senator BAUCUS. Well, in that case then, you think there should be a limitation which arguably will help bring land values down?

Mr. ASAY. Something has to be done.

Senator BAUCUS. I'm asking what should be done?

Mr. ASAY. I think it's obvious—eliminate tax laws which encourage landprices above the productive value.

Senator BAUCUS. Bill, did you want to say something?

Mr. YAGER. I think that the answer isn't to put some more provisions in the Tax Code to limit outside investment in agriculture, the thing to do is take out the things in agriculture that have encouraged outside investment.

Senator BAUCUS. Such as?

Mr. YAGER. I think that the investment tax credit for the hog business is one of the things that's really hurt the hog industry. And that, incidentally, was originally asked for by hog producers and now there's kind of a division in the national association, and they're tending—they're, I think, in the next year are going to come to Congress and say, "Hey, we decided we really don't need that, that it hurts us more than it helps us."

I don't think you want to restrict the flows of capital around the economy. And I know I sound like a libertarian, but I think you want the capital to go where it's needed. And I think the way to do that is to take out the artificial incentives that brought capital into some areas like agriculture that don't need any more capital.

We're in a position in agriculture where we want some of that capital sucked out. And I agree with Jack, I think land prices have to come down. I hate to say that since I've already got farm that's worth less than I paid for it, but I think it's going to have to go down some more if we're going to have long-term help in the industry.

Senator BAUCUS. Joe, do you have a view on this?

Mr. CARTMILL. Boy. That's a deep boat. I don't know. We slip on a lot of trails, and sometimes we don't know where we're going at times.

But, basically, I agree, the land values have got to get to a point where they pay for themselves by farm production. That's what our land is all about, or should be. That's the bottom line. If the land cannot produce to where the farmer can go in and pay for that ground and pay for the money that it takes to buy the ground, part of the money he has to borrow, buy some machinery, it's not working.

We've got the wrong people in the business. We have people that are family farmers that are disadvantaged with the big corporate farmers. They're given better tax breaks. So I don't know.

Senator BAUCUS. Back to hogs. How should the code be changed to treat all hogs the same? At least all sows anyway.

Mr. YAGER. Well, my suggestion would be to treat all—to eliminate what's in the code now, the capital gain—or the—under the present code you get capital gains treatment when you sell breeded animals.

And what I would rather see is all—is elimination of the distinction between breeding animals and market animals. Because like I say, that one animal out there in the corral can either be a breeding animal or a market animal. That's a very artificial distinction.

And I'd like—like anybody else, I like my tax breaks. I like that capital gains treatment on breedings animals. But if we could maybe reduce the total tax rate, then I wouldn't mind seeing them all put together.

Senator BAUCUS. That comes down to the $64 question. How many of you are willing to pay the price of eliminating a lot of deductions and credits in order to get lower rates?

Mr. CARTMILL. Yes.

Senator BAUCUS. You all are?

Mr. CARTMILL. I am. That's the goal that's been set before us.

Senator BAUCUS. You think we should pursue that?

Mr. CARTMILL. Yes.

Senator BAUCUS. I wasn't going to give you a hard time, but keep all these provisions?

Mr. CARTMILL. Yeah. I guess I was saying what was presented earlier, too. But those are helping the economy and all that, maybe they need to be considered to be left alone. If they're not, then take them out. But we do need to get to a point where we do leave it alone.

Senator BAUCUS. Before I leave you as a panel, I want to clear up a point about nonfarmer's investments in agriculture production. Bill Yager, you talked about maybe eliminating the ITC, which for the hog business might make some sense.

My question of all of you is, do you all agree that there should be no limits, no additional provisions in the Tax Code to limit nonfarm investment in farming operations, or do you think there should be some limits?

Mr. GILLIN. Can I——

Senator BAUCUS. Sure.

Mr. GILLIN. Our group is pretty much in support of this idea of limiting it to the national medium income, which would give like Bill and his wife on the farm, and his wife was teaching, her money could be pooled with the agriculture up to, say, $20,000 or $25,000. And that gives—under the present setup there's absolutely no way a young person is going to get into agriculture on their own unless one or both of them are working on the farm.

Senator BAUCUS. Bill, do you disagree with that?

Mr. YAGER. I think you have an either/or kind of situation. If you're going to leave all the tax breaks, special tax provisions that are in the code now, then I think that kind of limitation makes sense.

But I think if you cleaned up the Tax Code, if you treated agriculture like you treated the rest of the economy, that you wouldn't need that. We wouldn't have the problem of outside investment in agriculture. And that would be my preferred option.

Senator BAUCUS. As you go down that road, what are the major provisions that you'd like to see eliminated? ITC may be one. You mentioned capital gains somewhat tentatively.

Mr. YAGER. Well, I'd like to see agriculture treated the same as other industries, and this is where you get into the real problem on hog buildings. You've got a structure there that gets a treatment that's completely different from any other kind of building. If a developer builds a shopping mall, he gets no investment credit. He has to depreciate it over 15 years. But if he builds a hog complex, he can depreciate it over 5 years and he gets an investment credit. And that's where I think the problem is.

Senator BAUCUS. OK. Jack.

Mr. ASAY. Sir, I think we've always needed outside investment in agriculture. And probably always should have. I think the big problem came about when the incentive to be an outside investor in agriculture was financed by the laws which made it possible for the guy to end up with—you can't call it profit, but with money left over after a loss because of his ability to use the tax laws.

In other words, if the guy is wealthy enough, and he has enough deductions of a certain kind, he can come out with money in his pocket. Where the guy that's operating can't.

In other words, if the market were where the investor had to look for his return, he would not bid more than the land was worth and the guy who was farming could afford to compete in buying the same land.

Senator BAUCUS. Let's have a couple of minutes here. Let me turn away from agriculture to the code generally. I'd like to ask you which social objectives do you think we should maintain in the code?

Let's go down the line here. Anybody. What social objectives are proper, which ones presently in the code are improper?

Mr. GILLIN. I'm a little inclined to think personally that the Federal Tax Code should be for the purpose of raising revenue, not for the manipulation of the social economic——

Senator BAUCUS. So that would mean no interest deduction, no charitiable deduction, no State and local tax deduction?

Mr. GILLIN. If there is a corresponding lowering in the tax rate—and this is one of the things that was asked for in the testimony—is we will be able to live with all these things if they're corresponding with lowering of the tax rate.

Senator BAUCUS. Bill.

Mr. YAGER. I agree with Bill. I think if you lower the tax rate, and especially if you get it low enough, then those tax breaks aren't so important. And I would hope that none of us make charitable deductions to get a tax break.

Senator BAUCUS. I'm sorry, what?

Mr. YAGER. I would hope that we don't make charitable deductions in order to get a tax break.

Senator BAUCUS. A lot of people do, though.

Mr. YAGER. Well, we don't because we don't have a tax.

Senator BAUCUS. Well, there are a lot of people that do.

Mr. YAGER. Well, then I still think that the answer is to get that tax rate down. And depending on people's conscientiousness for charitable deductions, I really don't think the Government should subsidize those.

Senator BAUCUS. Jack.

Senator ASAY. I think we have a responsibility for the social problems we have to solve in the country. But on the other hand, nearly all of the problems that we're addressing today are a result of the use of the taxation system for resolving some of these problems.

Senator BAUCUS. Joe.

Mr. CARTMILL. Well, it all comes back to income tax basically.

Senator BAUCUS. Yes, revenue.

Mr. CARTMILL. I think we can go back to income tax, if you make a buck, give them a dime. Again, it's oversimplified. But, you know I'll admit some of these thoughts were put down prior to last night's——

Senator BAUCUS. Sure.

Mr. CARTMILL. Go for simplicity. Just go for it.

Senator BAUCUS. You all heard the first panel. The emphasis there seemed to be on keeping incentives for growth. Forget the simplicity. Incentives for growth.

Mr. CARTMILL. Again, you've got to be careful. Are we going to—let's don't overreact too quickly. Maybe we need to put this thing into a time phase kine of a thing. Maybe that needs to be looked at.

But let's get it back to, if you make a buck, give them a percentage. You know, that would be perfect if we could get to that without the complexities involved with that.

Senator BAUCUS. It's kind of interesting. The first panel, which was more for growth and less for simplicity, compared with your panel, which is a little more for simplicity to get growth, reminds me of a statement, an observation once made by American politics, and that is, all American political thoughts can be summed up in two sentences. No. 1, get the Government off my back. No. 2, there ought to be a law about that.

Thank you all very much. Thanks very much. I appreciate it.

We'll have a short—about a 10-minute break right now.

[A recess was taken.]

Senator BAUCUS. Our final panel is our professional services panel. Jim Bennett from the Montana Bank Association, Jim Koessler of Rocky Mountain Capial, and John Dostel.

Mr. DOSTEL. Yeah.

Senator BAUCUS. And Ed Davis. Is Ed here?

Mr. DAVIS. Yes.

Senator BAUCUS. And James Winchell. OK. Let's go down the line here. Jim, you can lead off.

STATEMENT OF JAMES D. BENNETT, PRESIDENT, FIRST CITIZENS BANK, BILLINGS, MT

Mr. BENNETT. Thank you, Max.

Although as a small businessman I embrace the concept of tax reform, I have serious reservations regarding certain of the provisions that have been discussed in the many tax reform proposals.

First, I think tax reform must promote simplifications of the tax system and thus increase taxpayers' respect for the system.

Second, tax reform should serve to eliminate the underreporting of income.

Third, in my estimation, of significant importance, tax reform should reduce the bias against savings and investments. Relatedly, tax reform should increase efficiency and incentives for economic growth. In this regard, reduction of the marginal tax rate goes a long ways toward improving the entrepeneurial spirit America was built on.

Fourth, tax reform must provide for an orderly transition where disruptions to the marketplace can be minimized and where past economic decisions not be penalized.

I think we should have a single corporate tax rate as all corporations are made up of individual taxpayers who are, for the most part, small investors.

I also feel the tax base should be broadened by taxing employee benefits such as health insurance and term-group-life insurance as they are as much a benefit as currency in the pay envelope.

Because most legal schemes to avoid tax liability originate with capital gains and investment tax credit, I feel those two provisions should be eliminated and small businesses should be allowed a faster depreciation system schedule with perhaps all items costing less than $10,000 to be expensed in the year of purchase.

If depreciation schedules are shortened, the amount of taxes owed would not change; however, less taxes would be due in earlier years, which would give the small business a chance to grow faster.

The Tax Code has been written and adjusted over many years to stimulate different parts of the economy and for other types of reforms. Because of these circumstances, many people with substantial incomes wind up paying a very small part of the tax. This has resulted in a feeling of unfairness toward the whole income tax system.

I think it is this feeling of unfairness that causes taxpayers to feel they are doing nothing wrong when they conceal income or do other illegal acts to lower their tax liability.

Senator BAUCUS. Thanks, Jim.

Jim.

STATEMENT OF JAMES H. KOESSLER, PRESIDENT, ROCKY MOUNTAIN CAPITAL, LTD., BILLINGS, MT

Mr. KOESSLER. Senator Baucus, thank you for asking me to appear before this hearing of the Small Business Committee.

My name is Jim Koessler, and I live here in Billings. I am president of Rocky Mountain Capital, Ltd., a closely held venture capital company. We also have two other venture capital vehicles, one of which is the only small business investment company in Montana licensed by the Small Business Administration.

I'd like to preface my remarks by pointing out that I'm appearing at the request of the committee. I'm speaking as an individual who's been a principal in small business entities in the past, and is now investing in somewhere around 30 small companies.

The complexity of the Federal Tax Code and its impact on small business is the first point I'd like to address. In my experience, new or small business entities are generally founded by people who have expertise in a particular product or service, but more often than not have limited or nonexistent backgrounds in finance or accounting.

They immediately find that they are devoting a meaningful proportion of their time to complying with tax reporting requirements to the detriment of the underlying business.

In addition to the time spend in-house trying to understand and comply with Federal tax requirements, they're almost invariably forced to seek outside help, accountants and attorneys, to get the job done properly.

In short, then, the new or small business has no alternative but to dedicate a substantial proportion of its valuable assets, people and money, to the totally nonproductive enterprise of trying to comply with the complexities of Federal taxes. Many small businesses are simply not in a position to sustain this burden.

A second but similar problem faced by small business due to the complexities of the Tax Code is a need to become deeply involved in tax planning and tax avoidance. Here again, certain resources must be allocated to outside professionals to assist the company in an area that has nothing to do with the promotion of the underlying business.

In summary then, our present tax system motivates American business to dedicate substantial amounts of time and money to nonproductive activities. The burden on the small business is disproportionately great given the scarcity of these resources with which they have to work.

In my small venture capital business, I would guess that about 10 percent of my time and many thousands of dollars a year go to these efforts.

It is essential that the tax codes be simplified so that they can be understood and complied with by the average small business in a reasonable amount of time without extensive outside help. A simplified code would also greatly reduce the burden involved in tax planning and avoidance.

Finally, I'd like to touch on the effects of tax laws on investment in small business. Through our activities as venture capitalists, we are constantly in touch with small business entities that are seeking equity investors. By definition, businesses that are small and new represent high risk situations, and consequently will not find investors unless those investors feel the potential rewards justifies the risk involved.

The point here is that if the rewards received by investors—that is capital gains—are subject to high taxes, the reward is diminished as is the incentive to invest.

There's absolutely no question that the removal of or reduction in the tax preference on long-term capital gains would result in the significant reduction in funds available for equity investments.

Senator BAUCUS. OK. Thanks, Jim.

John.

STATEMENT OF JOHN DOSTAL, ATTORNEY-AT-LAW, ANDERSON, BROWN, GERBASE, CEBULL & JONES, BILLINGS, MT

Mr. DOSTEL. I'm John Dostel of the law firm of Anderson, Brown, Gerbase, Cebull & Jones. I've been a practicing attorney for 8 years in a general practice and just 2 years ago received an advanced law degree in taxation. And I'm speaking from that background and my limited experience as a tax attorney for a little over 1 year.

I would also like to preface my comments by saying I started out trying to say something positive, and I thought I would say something positive, and I worked through a statement, and it's become quite cynical, I think.

To many of us, tax reform is an idea whose time has come. Instinctively we know we should feel good about paying taxes because it is basically the pooling of our individual wealth into a common fund which can be used to further our common societal goals and interests which could not be accomplished without the payment of taxes.

But we all know that this is not the case. Almost universally taxpayers begrudgingly send off their checks to the Federal Government each April 15 feeling that they have once again been fleeced by the Federal Government. We wish we were still an English colony so we would have someone to revolt against besides ourselves.

There is a general disillusionment with the present tax system that each of us pays more than our fair share. Whether this is correct or not, the present tax system is perceived to benefit the wealthy, big corporations, and special interest groups with a series of tax deductions, credits, and loopholes. There is a feeling that only the wealthy and criminal can avoid this unfair portion of the tax.

I perceive that this has been created because the tax system has been used to try and accomplish at least two contradictory and inconsistent goals. The first goal is that everyone pay an equal or proportionately equal share of the tax.

The second goal is that it is fair to have those more able to pay to pay a larger portion of the tax.

This reminds me of the campaign slogan of the infamous Wally Clark, the present municipal judge of Missoula, MT, whose campaign slogan was, "Equal justice for all, and a little bit more for my friends." The problem is, you just cannot have it both ways.

In trying to make it work both ways, we end up with a system that is seen as complex, unfair and unmanageable. Much of the time the tax is the tail that wags the business dog. However, strange as it may seem, the system works. Ideas receive investment, property is developed, and new businesses are created. Our economy may not be in great shape, but it is in good shape. We are the envy of most of our international competitors. Our dollar is strong.

A wholesale change in the system will likely be mostly illusory. The wealthy will always be able to best manipulate any tax law to their own advantage. The criminal will always disregard the law.

Further, our experience with tax reform under the present administration has consistently produced a shift in the tax burden from the more prosperous to the less prosperous.

Generally speaking, flat-tax proposals will continue in that direction. And it's my perception that that direction is not good for small businesses.

Within the business sector, we cannot get rid of a progressive rate structure and pay the same overall tax without increasing the tax burden of those lower on the economic scale.

As between the business sector and the consumer sector, we need to recognize that there is no such thing as fair in allocating taxes. Every business, whether large or small, ultimately passes on its tax burden to the consumer. If it cannot make a profit doing so, it will go out of business.

It does seem to be a necessary goal of our tax statutes to give some advantage to the small developing business. I presume that one of our economic purposes is to promote growth and the accumulation of wealth. This is best done through the development of a new concept, a new building, or a new business. The question is how to stimulate the new business into a going concern so that it can pay its own way.

Small business is seen as the golden goose of our society, and we must be concerned with killing this golden goose. Flat-tax rates do not accommodate new and developing business wealth. In essence, it protects the developed, static company and the wealthy individual.

The present progressive tax structure, which on one hand is more burdensome on the higher tax bracket individual or corporation, also gives it back in the form of tax deductions and credits. It may be the better system. Maybe we should merely work to fine tune the present system.

As to some of the specific concepts of the proposed tax reform, I would make a few short observations. Although the present Tax Code is extremely complicated, the complications generally do not work to either advantage or disadvantage of small business. Most areas of tax law began in reasonably understandable form. The complications have arisen either to give a break to a special interest group or to close a loophole to a special interest group. Most small businesses operate in the middle and do not get caught up in the complications on either side.

Second, capital gains benefits which advantage small business generally do not advantage them as much as the investor in the large established businesses. Small businesses generally are not promoted or developed on the basis of the tax consequences of its sale as much as the ordinary income it would hopefully earn for its investors.

Small business could live without investment tax credits. It could also manage with a longer depreciation period than offered by the accelerated cost recovery system. Both do provide incentive to the developing company, but are really used to a greater advantage by the established company.

Necessarily, the cash-flow in the small business precludes anything but necessary capital and equipment expenditures.

In our local Billings community, industrial development bonds are used for much, if not most, of new commercial development. The lower interest rates they provide make them a good deal for everyone involved in the development.

However, the financial community and the banking system are the ones that most benefit by the industrial revenue bonds. Again, which industry are we really trying to benefit through them.

Charitable contributions will continue to require a deduction if small business is expected to contribute. Frankly, there is no other incentive for small business to give to local charity.

The pension plan area is in dire need of reform. It is not understandable to even tax specialists. No one knows what will be allowed and what will not.

In closing, tax reform really appears to be a situation of tradeoffs. We decrease the deductions on the front end to increase taxable income, and then lower the tax rates on the other end. If the tax is the same, small business does not really care which method is done.

However, elimination of progressive tax rates must ultimately place the greater burden on the small business.

What I see happening with the tax reform proposals is a reduction of the higher tax rates while we will end up keeping all of the deductions and credits for the general advantage of those in the higher brackets.

It is my personal belief that tax reform is one area that has no experts, but seems particularly well suited to political give and take. Part of this give and take is whether you really buy the supply style theory economics or not.

Senator BAUCUS. OK. Who's next?

Ed.

STATEMENT OF EDWARD L. DAVIS, CERTIFIED PUBLIC ACCOUNTANT, GALUSHA, HIGGINS AND GALUSHA, BILLINGS, MT

Mr. DAVIS. Thanks, Senator. I'm Ed Davis, certified public accountant with Galusha, Higgings and Galusha in Billings, MT.

I appreciate the opportunity to appear before the Senate Small Business Committee hearing on the impact of the Federal Tax Code on small businesses. During the last 20 years I've had the privilege of being a tax advisor and financial advisor to many small business clients of our firm. Over those years I've come to appreciate the many and varied problems which small business owners encounter.

Virtually every business in our country today at one time or another was classified as a small business. Those individuals who chose to risk their time and talent in pursuing the American dream are entitled to a reward for their efforts.

Small business owners are daily faced with the responsibility of management, organization, purchasing, production, processing, marketing, credit management, personnel supervision. After addressing some or all of the above described activities and functions, most small business owners do not have sufficient time to deal technically or operatively with the existing tax laws. Nor are most so inclined.

I constantly ask myself whether small business owners truly don't have the time to become familiar with the tax laws, or whether the tax laws have become so complex that most small business owners are unable to devote the time and energy to become proficient in the area of taxation.

My conclusion is that both observations have some validity. That, one, the tax laws are complex, and, two, the small business owners do not have sufficient time to devote their energies to the tax law body and knowledge.

Therefore, the following scenario has developed. Small business owners have either knowingly or unknowingly transferred all or a portion of the tax knowledge responsibility to their professional tax advisers. With the transfer of responsibility for tax law knowledge, there's often a transfer of the accountability of the tax law as well.

Therefore, in many instances the professional tax adviser is the only link that the small business owner has with the operations and interpretations of the tax law. At the same time, the tax adviser is also bombarded with our clients' frustrations and lack of real or perceived fairness of the tax laws.

Professional tax advisers find themselves in the sole role of being the client advocate in dealing with the tax law and those individuals who are responsible for the administration and enforcement of such laws. Because most of the small business owners have transferred the responsibility for the tax law knowledge to their professional tax adviser, they have also transferred the accountability for those laws, and therefore, are not able to act as an advocate for themselves when dealing with the tax law and those individuals responsible for enforcement and administration thereof.

As a professional tax adviser, I find myself having a great deal of conflict in dealing with the client advocacy role which we find ourselves in versus the provisions of the tax laws dealing with preparer penalties. There's an old saying, "No man or woman serves two masters."

I believe that the professional tax adviser is placed in a role of serving two masters by being an advocate for the client as well as complying with the preparer penalties as now contained in the code. I personally dislike being cast in the role of a Treasury Department law enforcer.

In order for society to operate in a responsible manner, society itself must retain accountability no matter what the activity is. In my view, the transfer of responsibility and the related transfer of accountability of tax law and knowledge as well as its implementation has reduced the public awareness and the public input when it relates to tax laws. Change generally occurs only when the public itself becomes disenchanted, disturbed, or outraged by that particular issue. I believe that the public as a whole has not provided adequate feedback to our elected officials concerning their dissatisfaction with the complexities of the tax laws, because quite frankly, most of them don't understand the specific details of those complexities, nor do most of them have or choose to take the time to gain that intimate technical knowledge.

Therefore, the feedback that you as elected officials receive is in many cases from sspecial interest groups or professional who deal with the complexities on a day-to-day basis. That which seems relatively stratighforward to the professional tax adviser is anything but straightforward to the individual taxpayer.

In my view, in order to receive continued widespread public support for the public tax policy, the taxpayers themselves must regain part of the accountability for the tax system. The public must gain general respect and confidence that the tax system is fair and equitable. It seems to me that one doesn't achieve a goal in confidence and respectability of something which you do not totally understand or comprehend.

Therefore, it is my view that if it is the overall objective and goal of you committee to restore accountability to the public, then the tax laws must be simplified in a manner in which the public as a whole has the reasonable knowledge and confidence level in those laws.

The President's proposal which purportedly will make it unnecessary for countless individuals to file taxes doesn't necessarily mean the tax laws have been simplified. But it sure does reduce the number of individuals affected by the tax laws and the negative pressure on Congress.

Most small businesses, I believe, still view the basic concept of tax laws as representing the means for providing revenue in order to support the Government's various activities. However, it has become apparent that the tax laws have been used to cure many social and economic ills that are real or perceived.

In addition, the tax laws have been used to provide incentives and disincentives for certain groups of businesses or activities. The current Internal Revenue Code is no longer just a revenue producer. It contains a maraud of provisions affecting all kinds of activities versus those of strictly raising revenue dollars.

I believe that those provisions which have been enacted in order to cure our country's social illls and needs have also tended to erode confidence in the overall effectiveness and fairness of the taxation system.

The tax laws can no longer afford to be all things to all people. It's apparent that a change is needed in order to restore some reasonableness to the system as a whole.

Small business owners and operators are accustomed to change in operating environments of their own businesses. If the small business owner does not change with the mood of society as a whole, the quest for survival is in jeopardy.

Unfortunately change just for the sake of change does not always produce the most efficient results. Over the last 22 years, major tax law changes did not occur in only 3 of those years; 1973, 1980, and 1983. Major changes of the tax laws have occurred in 19 of the last 22 years.

Small business owners and operators who have planned for the future do so with the idea of achieving some consistent level of performance or some consistent method of operation.

It becomes extremely difficult for business owners and operators to plan when the rules of the game seem to be changing each and every year.

While I grant that many of the changes which have been enacted in the last 22 years were necessary in order to curb perceived or real abuses, other changes have only added to the complexities of the existing tax laws and eroded confidence in the system.

In summary, I would like to again reiterate that in order to survive, any tax system has to have the confidence and trust that there is some fair and equitable treatment of all taxpayers.

Frequent Band-Aid and baling wire changes to the existing system have led to an unmanageable, complex, not easily understood tax law. A tax law which has allowed the primary emphasis of revenue production to be diluted by the intrusion of non revenue-related provisions which are aimed at curing the social and economic ills of the public, also leads to a deterioration in the confidence in the fair and equitable treatment of all taxpayers that fall within its purview.

Thank you.

Senator BAUCUS. Thank you very much, Ed.

Jim.

STATEMENT OF JAMES P. WINCHELL, CERTIFIED PUBLIC ACCOUNTANT, JANKE, WINCHELL, EHRLICK & CO., BILLINGS, MT

Mr. WINCHELL. My name is Jim Winchell, and I'm a practicing CPA with Janke, Winchell, Ehrlick & Co., a local CPA firm in Billings.

I've been practicing as a CPA for the past 11 years, and during that period of time, I've seen many changes in the tax laws.

I am briefly going to elaborate on certain—or a few of the recommendations that the American Institute of CPA's gave to the Senate Finance Committee last August. I believe these recommendations are and still remain valid.

People today do perceive that we have an unfair tax system. It's a fact that people do perceive that. I pose the question of whether or not it really is unfair.

According to the Treasury Department's most recent estimates, families with economic incomes below $10,000 pay less than 2 percent of their incomes in income taxes. Middle-income families with incomes between $20,000 and $30,000 pay about 6.2 percent of their income in taxes. Higher income families with incomes between $50,000 and $100,000 pay about 9.4 percent. And the highest income families earning more than $200,000 pay about 21 percent in Federal income taxes. These statistics vary sharply with the predominant public perception of the distribution of the income tax burdens.

So therefore, I believe that the public should be educated on the past congressional efforts that have been made to make the law more fair, and this should have high priority. In other words, I don't think that the people are really completely aware of some of the income taxes that—or the amount of income taxes that a lot of wealthy people—so-called wealthy people, are really paying.

The second recommendation made by the American Institute of CPA's was that a bipartisan national tax commission on tax simplification, which was recommended in 1982, should also be appointed. And I think that part of its duties should be to study and report on the economic impact of any proposals, and certainly the Treasury proposals.

For example, certain changes being proposed, such as repeal of the investment credit, tax and capital gain as ordinary income, eliminating the intangible drilling expense election, limits on chartiable deductions are good examples of things that will drastically—or could drastically affect the economy.

One example that—of a change last year is the auto logs which has received so much publicity. And thank God that's been repealed. That's something that was rushed through, or put into law, which surfaced that they were regulations which were really not practical for people to live with. And I think there was much time and money spent to prepare logs and to try and understand the law that now has since been repealed. And there should have been more consideration on the impact of that law before it was enacted.

Another recommendation of the American Institute of CPA's is that a moratorium on legislation be enacted to permit practictioners and taxpayers time to comprehend the present law. Over the past 15 years we've had three major tax reforms and amendments during the other years which have changed the tax advisers' lives considerably. And it is becoming increasingly difficult for us to keep up with the many changes.

I think that all—the majority of practicing accountants believe that simplification should be adopted, which will focus on the needs of the majority of individual taxpayers and small businesses.

I think that before any more tax reform—or tax proposals are enacted, there should be specific recommendations solicited from practicing CPA's. The recommendations will undoubtedly not amount to a tax revolution, and certainly not an economic revolution, but it will be simplification to those who need it the most. I believe that the simplification, and education, and enforcement will raise the general effectiveness of the system and will avoid the necessity of experimenting with our economic foundations.

Thank you.

Senator BAUCUS. OK. Thank you all very much.

[The attachments to Mr. Winchell's statement follows:]

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FOR: Small Business Tax Hearing
Billings, Montana

FROM: James P. Winchell, CPA
720 North 30 Street
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Please find attached is a transcript of remarks made at a American Institute of Certified Public Accountants Federal Tax Division meeting regarding the Treasury tax reform and simplification proprosal.

I agree with the comments in the transcript and hereby present a copy of the transcript to be included as part of my testimony.

James P. Winchell, CPA

AICPA TAX DIVISION

Panel: Treasury Tax Reform and Simplification Proposal

December 11, 1984

Charles McLure, Art Friedman, Gerry Padwe and Arthur Hoffman

We have heard from Charles McLure and yesterday from Ron Pearlman. We have available to us the Treasury Report Volumes I and II all 670 pages. Volume III is yet to come! As you have heard, the Report recommends the adoption of a modified flat tax, applied to a very broadened income base. The changes proposed are massive; they reach every area of the tax law.

Let's understand what is before this Country. These proposals are like nothing we have seen before. Bradley-Gephardt and Kemp-Kasten pale into insignificance. This is not a modest proposal for simplification, or adjustment of rates, or the annual exercise in "loophole" closing. The proposals are no less than a tax revolution. In fact, the proposals would effectuate a political and economic revolution. In fact, the proposals represent an economic crusade. I am not saying its a bad crusade; I am merely saying it is a crusade.

The Report is a work of extraordinary academic scholarship. It is exceptionally thorough in its exposure of any provision of the Code where taxation does not coordinate perfectly with the economists' view of income. It also happens to be quite honest about the negative implications of the Proposals, and where it might be challenged.

We appreciate that honesty, and I would like to pursue some of the points raised by Treasury as matters which also concern us.

But who are we to comment?

It is my personal conviction that CPAs happen to be the most knowledgeable practitioners on the vital subject of the interrelationship between the tax law and taxpayer actions. Furthermore, we do not like complexity; we want the Code to be simplified; we do not want taxpayers to have the perception that the Code is so complex that only they pay taxes while the wealthy beat the system; and we do not like provisions which retard economic growth.

We have the credentials and we have good goals, and we owe it to taxpayers and Congress and ourselves to analyze the claims behind any wide-ranging tax reform proposal including those in the Treasury Report. If the claims are well-founded we should say so. If the claims are unsupported, we should say that too. We did this in testimony before the Senate Finance Committee in August.

Today, I have some observations about the Treasury Proposals, what they claim to accomplish, and how they would do so.

THE COMMENTS AT THIS TIME ARE MY OWN

The Report asserts that it is necessary to, and that the proposals would, if adopted, erase public perceptions about the unfairness of the tax system. The Report says that taxpayer morale and voluntary compliance is at stake. Changing the perceptions is at the heart of and is a compelling factor in undertaking a project which winds up being a tax revolution.

In light of this, there are two questions I wish to pose: (1) Are the perceptions true? and (2) Are they properly dealt with in the Proposals?

On question one, I refer you to Table 4.3 (p. 47). That provides rates of tax on "ECONOMIC INCOME." That's the good kind of income - all inclusive, even tax exempt income (p. 57). The table shows that the Family Economic Income Class of $200,000 and over has an average marginal bracket under CURRENT LAW of 46.1%! But, what of PERCEPTIONS! Isn't it supposed to be that it is in that bracket where all those abuses and sophisticated avoidances take place?! The same table also shows a growing progression of average tax rates paid in each family economic income class under the present system. So, perhaps a driving force behind the Proposals to revolutionize the tax system is no more than evidence of a lack of public education on the workings and effectiveness of the present system!

On question two, I have a real concern: Will the proposals change public perceptions? Indeed could they have been designed to do so?

Can a small taxpayer really be expected to believe that the proposals were intended to improve his perception of the system when he reads that a Big-8 firm computed Ronald Reagan's taxes under the proposal and found that his 1983 tax of $129,000 would have dropped to $88,000?

I mentioned that those who are in the economic income class of $200,000 and over now pay at a 46.1% marginal rate. The rate will drop to 33.2%. Can one imagine that the single person making $20,000 will perceive that he is being more fairly treated when his top bracket will move up from 23% to 25% and the individual making fantastically greater sums will drop 15 points to 35 percent?

These odd results in a system purportedly designed to change public perceptions arises because the Report sets out to maintain revenue neutrality and not redistribute tax burdens across income classes. But, if the basic public perception is that the rich don't pay, then setting out not to redistribute taxes is a concession either that the perceptions are incorrect (which would answer question 1) or that the perceptions are not worth addressing (question 2). In either case, the perceptions would be a weak foundation upon which to build a tax resolution.

I have the feeling that the average taxpayers' perception of the tax system may change as a result of the Proposals from unfair to grossly unfair.

In our testimony in August to the Senate Finance Committee we said that the economic system itself, to which the taxing system relates, is the most complex pattern of interacting elements known to man - perhaps only with the exceptions of the human body and the solar system. We cautioned against adopting another taxation system in the absence of sufficient study of the consequences. Throughout the Report the Treasury acknowledges that economic disruptions will occur.

However, the Treasury Proposals repeatedly state that provisions are premised upon the economic philosophy that a free market system will be to the best advantage of the economy. It is granted that industries initially will suffer (for example: real estate under at-risk rules; oil and gas when current deductions are not allowed for IDC; the capital intensive industries when ITC and ACRS are scrapped). However there are also assurances that all will be well. For example, it is acknowledged that the oil and gas proposals may reduce domestic production, increase dependence on foreign sources and raise prices. However, "the proposed reforms would be beneficial in the long run because the capital and labor released from the energy and minerals sector as a result of a more neutral tax policy would be employed more productively in other industries." And, "the public will gain from a more rational allocation of resources among competing energy modes."

These re-adjustments are explained in ringing free market economic terms:

> No longer will the allocation of the Nation's scarce economic resources its labor, its capital, its land, and its inventive genius be distorted by the biases of the current tax system. Instead, under the economically neutral tax system proposed by the Treasury Department, market forces will direct resources to those activities where returns are greatest. The result will be more productive investment and thus greater output.

I think back to what the AICPA said about the complexity of our economic system and its interrelationship with the tax system, and the need to study the possible consequences before disrupting the delicate balance. It reminds me of the medical problems of separating Siamese twins. And, sure enough, the Treasury Proposals contain a vital disclaimer which I must quote:

> "Although it is possible to identify the industries that would lose special tax preferences, it is impossible to predict the precise economic effects of the entire package of Treasury Department proposals on all industries and individuals in the economy."
>
> "...economic science simply is not sufficiently precise to allow accurate prediction of the effects of reforms as fundamental and pervasive as those proposed by the Treasury Department; accordingly, this Report contains no such attempt at precise quantification of economic effects." (p. 43)

The Report is grounded in the assumptions of free market economic theory. I have no idea whether it is true that disruptions will be resolved by the healing force of the free market system. But I am sure that economists other than those or Treasury's team are willing to debate the issues. The free market system is one which has not had a great deal of testing for many decades! I don't know the impact of eliminating the ability of Congress to grant and remove incentives in times of recession or an overheated economy. Do you? I do know, as a CPA-observer of taxpayer actions; that disruptions in the targeted industries are certain and will be deep and serious; that gifts to charities will be reduced; that tax exempt bonds will drop in price to accommodate tax rate changes and states will pay more to borrow; that plant and equipment purchases will decline; that home values will decline as their after tax costs increase. And, knowing what I know, it troubles me that a massive, all-pervasive change in the tax system should be vigorously promoted, and pushed onto the fast legislative track accompanied by a blanket disclaimer of its economic impact.

I discussed general problems I have with the Report: The assumption that it will effectively counter taxpayers' perceptions about fairness; and the assumption that the disruptions will not be too great a price to pay for the "noble experiment."

I also take exception to many specific recommendations in the report. I question them in principle, in the validity of their rationale, in the method chosen to solve the particular problem, or in their inconsistencies with other provisions.

We would be here a long time if I would take you through all 670 pages of the report and the notes I have in the margin. I will spare you, but I hope to put it into a commentary so as not to spare the Treasury Department.

I believe that the AICPAs recommendations to the Senate Finance Committee, given in August, remain valid.

- We believe that public education on past Congressional efforts to make the law more fair, should have high priority.
- We believe that a bipartisan National Commission on Tax Simplification first recommended in 1982 should be appointed.

We believe that part of its duties should be to study and report on the economic impact of any proposals, and certainly the Treasury Proposals.

- We believe a moratorium on legislation is necessary to permit practitioners and taxpayers to comprehend the present law.
- We believe that simplification should be adopted which will focus on the needs of the majority of individual taxpayers and small businesses. We endorse suggestions in the report to raise exemptions and the zero bracket amounts and introduce a return free system. The AICPA has previously endorsed indexation.
- We will make specific recommendations. They will indoubtably not amount to a tax revolution; and certainly not an economic revolution. They will merely be simplification proposals for those who need it most. We believe that simplification, education, and enforcement will raise the general perception of the effectiveness of the system and will avoid the necessity of experimenting with our economic foundations.

Senator BAUCUS. Ed, you made an interesting point about how members of your profession are serving two masters. One hand serving the Government, the other hand serving your clients. I understand that.

But another interesting observation is that because so many people have transferred their tax problems over to their preparers, they're not as aware of all the complications. They're aware of some of them, of course. But not as much as you are.

You seem to say the solution is that somehow Americans have to be more a part of the process, more involved in the tax laws and better understand them, and that you think that will help create more confidence and accountability.

You all seem to talk a little bit about simplification. Although I'm not sure that's easy to do.

OK, let's make some hard decisions here. Which provisions of the code should be cut out? How do we simplify? Which social objectives should we pursue? Which ones should we not?

You know, we all like to say the code should be more simple, but if we make it more simple, we've got to decide what to ax, what to cut. So if we agree with the premise that the code should be more simply—although we may not all—but if we agree with that premise, where do we start cutting? John.

Mr. DOSTEL. Part of the reason why I think it's next to impossible to simplify the code is, one of the provisions to simplify, if you cut out capital gains tax treatment, that creates almost all of the complications involved with tax shelters, or much of it. Most complications in corporate law is a determination of how to get around paying ordinary dividend income and transfer that to the shareholder as capital gains in terms of sale of stock.

Now, if you got rid of capital gains, you would get rid of most of the—or many of the complicated provisions of the code. However, you talk to economists, and you can't get rid of capital gains and foster investment.

So—I mean, you're right in talking about the tradeoff between what do we get rid of and what do we keep in terms of, do we have social—do we aspire to social and economic goals in the tax codes or simplifications?

But as I see it, the economic goal of having capital gains is almost necessary economically, and as soon as you have a difference between capital gains and ordinary income treatment, you immediately have tax shelters, complicated corporate laws, complicated individual laws is, what is capital gains treatment, and what's ordinary income treatment? And that has generated much, if not most, of the complicated sections in the Tax Code.

And I think most people economically say you can't get rid of capital gains and foster investment.

Senator BAUCUS. Well, is it possible to simplify capital gains treatment in the code? Or is that impossible? Can't you just have a simpler provision that—like the first amendment, let's say—is very general? I know it's not the same as free speech, but——

Mr. DOSTEL. If you change the whole enforcement structure of the Internal Revenue Code, you could, because free speech is a simple law. Where does it get complicated? In the courts and jury trials. And then anyone—any attorney that's dealt with free speech knows it's far from simple.

The law is simple. People think they understand the law. Anybody's that's been a witness at a trial, a victim of it. The same with a car accident. Laws are not simple of their very nature.

The negligence laws and the statutes are simple, but there's probably more law produced on what is negligence and not than the Tax Code. Only attorneys understand it. Only attorneys get involved with it.

You make it a jury issue, you can change the tax laws to one-line simple definitions. You can get rid of the regulations, then have tax courts and juries decide those issues and have volumes of case law.

Senator BAUCUS. I'm playing devil's advocate—why isn't it better just to cut down the number of tax judges?

Mr. DOSTEL. Along that avenue, did the Federal Government reduce the amount of Federal district court judges? No, they just added a couple hundred in the last year because the law is of the nature, if it's in front of judges and courts, you know, people are going to be in there arguing over what is capital gains, what is ordinary income. And every situation has a different factual determination.

Senator BAUCUS. Let's set all the implementation problems aside for a moment. Is there a way to simplify it?

Mr. DOSTEL. That's why I said I started out trying to say it would be real nice to simplify it. I don't think any law is simple.

Senator BAUCUS. It seems we've got two choices. We either try or we do nothing. Are you telling us that we should do nothing? Or are you telling us we should try?

Mr. DOSTEL. I'm saying a simplified code is—I don't think you can simplify it. I think you can refine the code to be more fair, the code that we have. But it really won't end up being a simpler code.

I've kind of kept this for awhile. I'll pass on.

Senator BAUCUS. Who wants to tackle the question I asked, that is, what do we start cutting out?

Mr. DAVIS. Since I kind of started part of this, too, that there isn't any doubt in my mind that in—I believe it was 1913 when we first started this process—that I would suspect—and I have not looked at one of those returns for a long, long time—there really wasn't very much on those original 1913 returns. I believe that they were on a piece of paper that was probably, oh, 14 inches long and 8½ wide and was on both sides. And it was relatively simple at that time.

And I would suspect maybe even back then the concept of capital gain taxation wasn't around. I believe probably the biggest piece of it had to do with your name and address and that sort of thing, and how much income did you have, and send us a percentage portion.

The thing—to me, the thing that has gradually crept into the system, and as I tried to point out, is that in order to either spur the economy for whatever reason, or to either cure some social ill, or to provide some particular special interest group, or provide some special economic assistance to a low income group, the tax law itself has built into it now all these provisions that have to do with stimulating the economy, providing special rules for special groups. Those rules, in order to provide that assistance, when they were adopted, I'm sure the intent was to make it relatively narrow. To do that, it made them complex. And they are.

And so if you truly want to simplify it, I think you're going to have to rethink the basic concept, a tax law containing provisions that have to do with curing the economic and the social ills of the country, and special interest groups, and create instead a tax law that is simple that produces revenue.

Senator BAUCUS. Well, that's what we first had, a tax law that was much more simple and produced revenue more than it attempted to accomplish social objectives. The first income tax law was proposed by President Lincoln to finance the Civil War, and the Supreme Court struck it down. And other attempts were also struck down until the 16th amendment of the Constitution was finally adopted.

And the first version of our current income tax was primarily a revenue raiser, until about 1962, when President Kennedy proposed major changes. He proposed a lowering of the rates, and also proposed the ITC to stimulate the economy. And it worked.

And as a consequence, lots of other groups said that if that worked, maybe it can work in my little area, and stimulate my little segment of the economy.

So that's what happened. At the time America was pretty wealthy, prosperous, in the late 1960's. And it's paying the piper right now because we have all these provisions in the code.

Now, maybe we can go back and undo what we've done. But that's a very, very difficult road to take. It's pretty painful.

But are you saying we should do that?

Mr. DAVIS. I guess, if the public really wants to restore its confidence in the system, that's what I believe has to be done. I believe it has to be converted back to a revenue producer.

If Congress in its wisdom then chooses to adopt economic or other social reforms or directions, then let them do so in another manner. You don't have to mess with the revenue producing bonds to do those things.

Senator BAUCUS. Well, that raises an interesting question.

Mr. DAVIS. You've done so in agriculture, you've done it in other areas.

Senator BAUCUS. That raises an interesting question. Many people, as you well know, have gone to the Tax Code to accomplish certain collective objectives thinking it's more efficient than having a government agency do it. Say housing, instead of having a housing agency doling out money to people to build homes, we have the mortgage interest deduction. It's more efficient, less bureaucracy, selective, in the private sector, et cetera. And something I think can be said for that.

Mr. DAVIS. Excuse me. Instead, what we've done is we've turned the responsibility for enforcement over to the Internal Revenue Service. And, you know, while we work with the code and regulations with our clients, that certainly is not 100 percent of the practice, or accounting practice in Montana. We do a lot of other things besides taxes and tax consultation and planning.

But, you know, the task for enforcement with the body of knowledge is vast and broad, is almost staggering to be placed upon one agency, responsibility to enforce and administer with a happy, friendly face.

Senator **Baucus**. Are there any objectives you think we should keep, or pursue? For example, the IRA's? Savings? Mortgage deductions? Housing? Charity?

Mr. **Davis**. Every time you add an additional act, it complicates——

Senator **Baucus**. I understand all that.

Mr. **Davis**. Every time—you know, it reminds me of—you know, we talk about, "Well, should we take all of these deductions in a way that we have to add to some special preference." It's amazing what happens when oftentimes you give taxpayers, individual taxpayers, a choice as to whether they will dedicate their resources to this particular option or this particular option, or take their resources and put it in their pocket. Oftentimes we find that those resources, they can get by with less and stick the balance in their pocket.

So perhaps some of the deductions, you know, if the need came to it, are able to be better utilized in a more efficient manner by having that option themselves at the individual taxpayer rate, whether it's business or whether it's at the individual level, instead of having the tax motivation entering into the decision.

Senator **Baucus**. Do most of you agree with that same——

[Responding: "Yeah." "Absolutely."]

Mr. **Bennett**. I think that the confidence in the income tax system is at its low. I see people all the time that I know are not paying their share of the tax. As a matter of fact, most corporations that are making money and are profitable do not have to pay tax if they don't want to. It's a matter of public policy that they pay taxes. If they want to get into the many different types of investment schemes that are available, convert their income to capital gain, do not have to pay taxes.

Senator **Baucus**. So then do you agree everything should be cut out? Do you keep something? I know it's hard here today to be specific. But you must have some sense as to how far to go to clear the decks.

Mr. **Bennett**. I just don't think the present system is going to work very much longer.

Senator **Baucus**. So do we clear the decks completely?

Mr. **Bennett**. I think social reform should be separate from tax laws.

Senator **Baucus**. Do you consider housing a social reform?

Mr. **Bennett**. All that should be separate from tax laws.

Senator **Baucus**. So housing, forget the IRA's, don't try to encourage Americans to save more? The Japanese do, if that's important.

Mr. **Bennett**. I don't know if they pay taxes.

Senator **Baucus**. They do. The first $50,000 to $60,000 of interest income is exempt as an incentive to stimulate savings.

Mr. **Bennett**. They're using a different type of tax system. They're taxing consumption.

Senator BAUCUS. Anyway, there are carrots. IDB's? Look what IDB's have done for Billings.

Mr. BENNETT. Look what they've done for banks. A lot for Montana.

Senator BAUCUS. All over the State. Do you think IDB's should go?

Mr. BENNETT. I don't know that they should be gone. They should be gone from the Tax Code. If we want to subsidize that type of thing, it can be done in another way.

Senator BAUCUS. Jim.

Mr. WINCHELL. I agree 100 percent with what Ed said, but I'd like to—in answering your question, I think there needs to be more study on the economic impact of these things, eliminating investment credit, charitable deductions.

Instead of making changes every year, I think they need to sit back and look at these things.

You mentioned earlier in one of the other panel discussions that the Treasury Department had not made any impact studies. I think there needs to be a period of time where they can study these things before you can really say whether or not this should be changed or that should be changed.

Senator BAUCUS. Yes.

Mr. WINCHELL. I think things are being changed too fast without enough studies. A good example is auto logs.

Senator BAUCUS. There have been a lot of days and a lot of hearings, but still that's not enough to officially appreciate the effects that a lot of these proposals are going to have.

How about capital gains, though? Everyone says the same thing. It's needed. Or else as you said, John, it accounts for a lion's share the complexity of the code.

Ed.

Mr. DAVIS. Senator, I just want to go back for a moment to the agricultural panel. I think that panel hit on land values and the problem that it creates.

But I can assure you that the biggest shock that the agricultural people have is when they bought the land 40, 50 years ago, relatively small dollars per acre, they go to sell it now, during these interim years that have been very difficult, in most cases—not in all—but in most cases, the borrowing has kept pace with the inflation on the land. The tax impact upon disposition of the land, even in capital gains, the alternative minimum tax, absolutely is the biggest shock to some of our ranchers and farmers that I see. And oftentimes it will be a large enough shock that they'll say, "No, we're not going to sell." Can't afford to.

Senator BAUCUS. So what do we do about that?

Mr. DAVIS. Well, you know, it's a situation where I don't have an answer to the agricultural land situation to moderate that. But it seems to be that the overall policy of holding assets for long, long, long periods of time, to have income even at a lower rate dumped into one particular time period is really—it's just a real burdensome problem. A real burdensome problem on their industry that may not have anything to do with the fact that the reason why the agricultural industry is in a, quote unquote, wreck may not have anything to do with the circumstances that they control.

Our country has been very generous with its technical knowledge of how to produce food and fiber for the world. In effect supported it. I think that if you will go back 20, 30 years, you would find that the world as a whole relied more upon the United States as a whole for their food and fiber.

We've exported technology, taught the balance of the underdeveloped countries to produce their own. And now in many instances those folks are exporters in the world market. Food is a world market, not just a Montana market. Or a U.S. market.

And so consequently, I think our agricultural people are caught in a catch-22 situation. And I don't have an answer. All I know is that that's a real shock to them when it comes to, quote unquote, a lower capital gain when they go to sell that ranch or farm.

Senator BAUCUS. Well, it's severe all right. I mean, India, of all countries, is self-sufficient in production of food. China is also an exporter, or at least self-sufficient in the production of wheat. The Soviet Union, I think has a joint venture, as do some other Communist block countries, with American firms. And that's going to reduce the need of the Soviet Union to buy grain from the United States.

We exported $41 billion of agricultural exports in 1980. And now it's down to about 34, $33 billion. It's partly due to the value of the dollar, but it's also due to the greater efficiency of other countries. They're not going to lose that efficiency either, they're learning. It's a severe problem we're facing.

Mr. DAVIS. You know, the Government's policy is to keep food prices low so that all Americans have cheap food so that they can go to bed with a full stomach.

Senator BAUCUS. Should we exempt some farmers from the alternative minimums so they aren't faced with that big whopping tax?

Mr. DAVIS. If I'd had a solution, I'd have come forth long before now. I'm not sure that that's fair to the balance of the segment of the economy to segregate again a special interest group and say, "OK, we're going to exempt you totally."

Senator BAUCUS. I might just parenthetically add here, though, what really struck me, today's Wall Street Journal—I don't know if you saw it—there's an article about how Japan won a major bridge contract in Turkey, building a big bridge over the Bosphosus over there in Turkey. And they came in with a bid much below other countries, probably because it's a Japanese company working with other companies. Other countries around the world weren't able to get very generous concessions, and the Japanese Government gave a $200 million loan at 5 percent.

But the very last sentence, it's a quote by the head of the Japanese company, and he said something to the effect that in commerce, nothing is fair or unfair.

Let me get some futher reactions. What about capital gains, Jim?

Mr. KOESSLER. Traditionally capital gains were never taxed. It's a different kind of animal than income taxes. And I think for the creation of capital and encouragement of equity investment and so on, I would argue for no capital gains tax. But certainly you don't want to raise them above the present levels.

And I tried to find some literature I had that showed during the period of the 1970's when they had increased long-term capital gains taxes, there was a direct correlation between that and reduced investment in the venture capital industry, which is pretty well defined and easy to look at. There really is a correlation there.

Senator **Baucus**. Ed, if you don't mind, you commented on the question that was last addressed, that is, there should be farm loss offsets against other income? What's your view on that?

Mr. **Davis**. My recollection is that it hasn't been very many years ago when the tax law had an animal called the excess deduction account, which was an attempt to limit farm losses being offset against other nonfarm income. The proposal was around for, oh, maybe 3 or 4 years. And then finally it just kind of died a waning death, and I believe it was repealed.

The problem with it is, when we worked with it back then, it was very complex and probably one of the most complex sections of the law. It's probably been over 10 years ago. Maybe about 10 years ago. Very difficult.

My recollection was that there was a limitation of $25,000 worth of loss that could be offset against nonfarm income, and you had to keep what we called an excees deduction account off to the side, and a memo entry set of accounts. And it was the craziest thing I'd ever heard.

Obviously, whoever put that—came up with that idea had not had to come out and work for the ag people in a real-life situation. It was an absolute disaster.

And based on what I see in the last several years, you know, we got quite a number of ag clients that have losses. And some of them have some other modest outside income from trusts, family trusts or whatever.

So I guess what I saw before didn't make me very impressed or encouraged that a provision like that would operate very well.

Senator **Baucus**. So basically what you're all saying is we will achieve the goal of economic growth not by making the code more complex with additional incentives written in the code, but rather we achieve the goal of economic growth, paradoxically, ironically, through achieving another goal, and that is simplicity. That is, you eliminate a lot of the tax expenditures, you get lower rates, and with the lower rates, people spend less time worrying about the code. And also indirectly lower their rates, their economic position will not be a worse position, but maybe even be a better position. Is that what you're basically saying?

Mr. **Koessler**. I think so. And allowing people to make the best decisions based on the underlying economics.

Senator **Baucus**. And that's what you say to Bruce Crippen, who suggested we've got to work toward incentives, attract capital to Montana. So your answer would be, "Well, the way to do that is along the lines we just outlined rather than"—I don't mean to set you up against Bruce, but——

Mr. **Koessler**. Yeah, I don't know about Bruce. But it could be argued that the strength of our country has been developed through people investing money where they think they will make money. It's the capitalistic philosphy. And I think it's worked pretty well.

I think when Government steps in and says, "No, I think funds should go here and there and there, because we know best," sometimes it works for brief periods, but overtime it's very inefficient, creates large bureaucracies and is very expensive for the American public.

Mr. DAVIS. I'd just like to finish with one observation on the simplification that was proposed by the President, and perhaps where we ultimately end up.

Experience tells me in the past that the most successful groups in tax legislation change have been those that have been well financed special interest groups, because they've been able to tell their story best convincingly. Those lawmakers that make the decisions, that their position is best.

I see the small businessmen and also the individual taxpayer as not having a big voice in that decisionmaking.

Senator BAUCUS. That's right.

Mr. DAVIS. So in the tax simplification, and to try to say that we're going to do away with everything, it's my perception that the lobbying efforts by those special interest groups who have—whose interests seem to maybe disappear the most with pure revenue production type of a system, the pressures are just going to be incredible on Congress.

And I guess speaking from a little cynicism, I'm not terribly optimistic that there will be simplification. You may have some reform, but I'm not convinced that the code is going to be any less complex than it is right now.

There may be some modifications of rates, which to me is not a simplification. There may be some elimination of deductions, which is not particularly a simplification. It's just a modification.

But I don't think we're going to see as a whole, the system really overhauled so it is simple. And that I think is terribly disappointing.

Senator BAUCUS. Well, it's a good point, but there's something you can do about that. I know it sounds trite, as everybody always says. But sometimes the trite things are often most true. And that is that, sure, various groups, industries, benefactors, the provisions in the code are going to do everything they can to keep those provisions in the code. They're organized, they're financed, they have access, they have great public relations skills, and they will do everything within their power, in all the ways they can, to protect their positions that are carved out for them in the code. That's true.

Now, some of those—a lot of those groups are working against each other, too. In fact, they've muddied the waters a little bit.

But more than that, it's up to people such as yourselves to also get involved.

And there are ways for individuals to get involved. It's the phone calls to the congressional delegation. It's the letters that you write yourselves. It's followup.

You know, any company, any organization and industry, a trade association will spend a lot of time protecting their position.

I think if Americans—Montanans, if American individuals, citizens were to spend just 10 minutes a day, or 10 minutes a week getting involved with the phone calls or letters, it would make a tremendous difference. and that's what's going to determine whether this thing goes through or not.

First the President follows up and stays behind it. And second, the degree to which the American people are also aroused and want to get involved in this. The third is the Congress. But as much as I like to think Congress leads, and some Members of Congress lead more than other Members of Congress, still Congress tends to follow what it perceives are the wishes of the people.

So it depends on a lot of wishes of the people here, and I strongly urge that anyone who may be listening, anybody else you talk to, that you can get involved, and you can get involved very effectively with personal phone calls to people—there's four members here of the congressional delegation—all four of us. Don't be sidetracked by a staff person, say you want to talk individually to John, Ron, Pat or Max, And follow up the next week, see how things are going, the third week, and the fourth week.

You know, all anyone has to do is just make that little effort, and I'll tell you, there would be a tremendous effect. If those people call up and say, "Hey, we want it simple, don't listen to all those special interests, and stand up for America," it would make a big difference.

Thank you all very much.

[Whereupon, at 12:20 p.m., the committee recessed, to reconvene at the call of the Chair.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

WEDNESDAY, JULY 3, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Boston, MA.

The committee met, pursuant to notice, at 9:30 a.m., in conference room No. 1, 21st floor, McCormack building, Boston, MA, Hon. John F. Kerry (acting chairman of the committee) presiding.

Present: Senator Kerry.

Staff present: Tom Walsh, Stewart J. Hudson, Monica Conygnham, James Brenner, and Robert Baker.

STATEMENT OF HON. JOHN F. KERRY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KERRY. The hearing will come to order.

First, I'd like to express my appreciation to all of the witnesses who have taken time out of what I know are very busy schedules to join us today, and also those of you who are here as a matter of interest to focus with us on this very important issue.

This is a formal hearing of the Senate Committee on Small Business. It is a continuation of hearings which have been held in Tennessee, South Dakota, Illinois, Montana, and now here in Massachusetts. It is a reflection of the significant concern of the membership of the Small Business Committee with the impact on small businesses of the proposals for tax reform and with the current situation with respect to small business in the country.

I don't need to tell anybody here how important the outcome of this debate is going to be; not just for the future of small businesses here in Massachusetts or elsewhere, but, I believe, on the overall competitive posture of the United States, and I think that the underlying—or one of the underlying—themes which is certainly guiding me as I listen and try to sort my way through some very broad, sweeping proposals, is really how they are going to ultimately impact our ability as a country to be able to compete in a new, international marketplace and to continue to fundamentally remain or be No. 1.

Now, as all of you know, the President has gone through two proposals now—Treasury I, which was not attributed, necessarily, directly to the President, and now the second proposal. It is an ambitious and sweeping plan for tax reform, and for the next several months it will be one of the major domestic economic issues facing the Congress.

There is tangible support in Washington and throughout the Nation for the general concept of tax simplification and rate reduction, and I have personally been committed to the goal of simplification for some period of time. But while tax reform can take many forms, it is inevitable that significant rate reduction without a loss of revenues requires broadening of the tax base through the reduction of some of those deductions and credits and preferences which have existed. And the economic implications of those changes can be profound; therefore, we must be cautious as we move ahead.

For small businesses, as for all taxpayers, informed participation in this process is critical. Your comments and the questions and answers thereto will be made a formal part of the Small Business Committee hearings and of the Congressional Record.

I think all of us in this room share an appreciation for the fact that Massachusetts has a particularly important role to play in this debate because even while we are showing some strains today from the large deficit that we have, as well as from the international trade deficit, it's clear that we still have the single most healthy economy of any industrial State in the Nation. And I don't think I need to remind this audience that it is more than the 100,000 small businesses throughout Massachusetts which have been the driving force in this remarkable success that we've felt.

Now, unfortunately, I think the Reagan administration in its approach to small business has been less than sensitive to what small businesses have done for this State and for the country. The proposal to abolish the SBA, which Senator Weicker, the chairman of this committee, Senator Dale Bumpers, the ranking minority member, cosponsored a response to, showed that kind of insensitivity this administration is prone to, and should serve as a warning signal to all of us.

The question is, how does the Congress select between the competing claims which are inevitable as we approach tax reform. It seems to me that there are two driving criteria that we should adhere to. One is fairness. Obviously, what is fair to one person may not be to another, so we have to walk our way through a difficult minefield on that, but I think the American people have a basic sense of what fairness is, and we have to try to achieve fairness in this process, making taxes and the system less burdensome for the average taxpayer and for small business people.

The second criterion is to improve the long-term effectiveness and performance of our economy. Now, it appears to me and to others that in many ways the President's proposal falls far short of both of those goals, and that it will have to be substantially changed by the Congress. So I think it's important today that we take a look at the problems that may arise, whether they are difficulties in bookkeeping and accounting, or whether they are difficulties in basic concept which are going to render small businesses less competitive and make life more difficult in an already difficult and competitive world.

I also believe that it is critical that the current debate does not divert us from what I think is the most fundamental problem that we face, which is reducing the budget deficit and the trade deficit. And in connection with that, I am personally determined that we are not going to allow this process to become a subterfuge for a tax increase.

So with those opening comments, I want to welcome all of our panels. I also want to welcome from the Senate committee staff here Tom Walsh and Stu Hudson, who have joined us to represent the majority as well as the minority and to help staff this.

I really want to thank all of you for taking the time, and particularly the panels that will speak. Now, there are a number of panels—let me just lay the ground rules here. We will run this in the same manner that we do the hearings in Washington in the committee room. There will be a period of time for statements by each of the panelists, then I will ask some questions—perhaps, or perhaps not—and we will move through the panels. At the end, if there is any time, I may or may not have a moment to ask other questions for the record.

Those of you who have come who do not have a chance to participate by virtue of formal invitation, I would like you, at the end of this meeting to speak with Nancy Ramsey and Jim Brenner from my staff in Washington or with Bob Baker and Francis Carroll, who serve on the Senate Small Business Committee's Advisory Council. We would be happy to have you connect with them, please, because I want to make certain that if you have any questions, that we have a chance to answer them personally; or, second, if you have suggestions or comments that you want to add, I would like to make that opportunity available to you. So I want to make certain that nobody is left out of this process.

In trying to set a guideline for the panels—we have four panels, total—that's a fair amount of time, and so I would like to ask panelists if they have formal statements which they have already submitted for the record and they feel comfortable with the notion, I might ask them if they would be willing to summarize or give a precis of those in order to really put the bottom line before us as rapidly as possible. If you are not comfortable with that, then I understand. But I think it would be helpful if we could get to the substance as rapidly as possible, and all of your submitted statements will be made a formal part of the record.

The first panel represents high technology and venture capital, as well as academia, and I'm particularly pleased to be able to introduce the third member of that panel, who was one of my tax teachers at law school and who has been extremely involved with Senator Bill Bradley, with Senator Kennedy, and with a host of other people in helping to construct some of the proposals that currently are on the table and to serve as an advisor to a great many people with respect to where we are going, and that's Prof. Paul McDaniel from Boston College Law School. And I'm also pleased to welcome Ms. Betsy Walkerman, who is senior vice president of Aspen Technology in Cambridge, MA, and Mr. Jack Nieses, who is a partner of Charles River Partnerships in Boston. So if we could begin with Ms. Walkerman, I would appreciate it if you would make your statement for the record. Thank you.

STATEMENT OF BETSY WALKERMAN, VICE PRESIDENT FOR FINANCE AND ADMINISTRATION, ASPEN TECHNOLOGY, CAMBRIDGE, MA

Ms. WALKERMAN. Thank you, Senator Kerry. I appreciate the invitation to participate in this hearing. It looks as though we have a small cadre of the alumni of Professor McDaniel's tax courses. I am also a member of that.

I am vice president for finance and administration of Aspen Technology in Cambridge, and I've been associated with the company since its founding in 1981. I am a lawyer by training but my practical experience is primarily in finance and business, with some related tax work.

I am speaking from the perspective of a small, growing high-tech company. Aspen Technology is a leading supplier of state-of-the-art software technology. We supply software to the chemical industry, and the petroleum industry, among others. Software is used by chemical engineers to simulate chemical processes; this allows them to often avoid pilot plant stages and extensive testing in their work, and allows them instead to simulate what's going to happen in that chemical plant on the computer. The result of using this technology is often technological advances in their processes and the efficiency of their plants.

We are a part of what's often touted as the high-technology New England community, and we certainly try to be everything that people say we should be—tough, energetic, pragmatic, and, above all, profitable. Well, generally it's the Treasury Department who wants a slice of those profits, but in asking for our comments here I assume that the committee is more interested in our energy and pragmatism.

I'd like to give you my conclusion first. Senator Kerry suggested that we get to the bottom line. In my view, the concepts embodied in the three tax reform proposals are very sound; yet, I also conclude that the timing is wrong, and I'd like to just explain what I mean by that.

First of all, the concepts. The general concept of lowering corporate and individual tax rates is a tradeoff for reducing or deleting certain credits and deductions. It makes good sense to me. Academically, if we were starting from scratch, this may be very close to what we would come up with. From a corporate point of view, setting the rates relatively low allows businesses to channel profits into future investment in growth of the company.

Adopting a small number of tax brackets at the same time keeps the tax burden on small businesses somewhat lighter.

Having a "clean" calculation of income which is not artifically distorted by short depreciation schedules would promote fairness in the system.

Providing no special tax credits allows the tax system to concentrate on evenhanded revenue collection rather than on economic policy.

In practice, though we're not in any ivory tower and we're not starting from scratch. The effect of incremental changes is important, and the incremental changes in these tax reform proposals are monumental. As with any change, there are winners and losers, and there is dislocation.

For business, for several reasons, the proposals send the wrong message; and the message I want to concentrate on is the message about investing.

We currently have two provisions that encourage investment in plant and equipment—the investment tax credit and accelerated depreciation schedules. Even at Aspen Technology, which is not a capital-intensive company, these provisions have allowed greater flexibility and more certain growth because they reduce the cost of some of our key equipment, our large computers.

However, looking at the whole package, for a service company, for a high-technology, non-capital-intensive company, the reduction in corporate tax rates, I believe, would more than offset the loss of certain benefits from the investment tax credit and from accelerated depreciation schedules.

So I think—without running a lot of numbers on my computer—I think that we would be one of the so-called winners in this game.

That would be narrow mined. It would be narrow minded to look at a proposal just from the viewpoint of our little company or our little piece of the industry. The reason is that our customers are capital-intensive, and abolishing the investment tax credit and the shorter depreciation schedules affects them. Anything that affects another sector of the economy affects us. Similarly, abolishing the R&D tax credit would send the wrong message to industry. This one, of course, would affect us more directly; but again, I am just as concerned about what happens to those capital-intensive industries out there, the petroleum companies, the chemical companies, who are our customers and who form a base of strength in the economy of this country.

So I think that we must take as a given that there are dislocations and there are messages about investment and growth that would be sent as a result of implementing these tax proposals.

That doesn't really bother me as long as we are in a position to do this. We always have a price to pay when you want to introduce a reform that's important to other considerations, such as fairness. However, I don't think that we're in a position of strength, and the reason that I conclude that is because of the budget deficits. In adopting a tax reform package there is a risk, and that risk is that we would generate less revenue than we expect. That's a very serious risk and one that's already been confirmed, I understand, by the Congressional Budget Office, which is now estimating that the President's tax proposal would result in revenues that are significantly lower than the revenues that are generated under the current tax system.

Frankly, the budget and the deficit are of far greater concern to me in the context of Aspen Technology's business than any of the changes proposed in the Tax Code. Like many other high-technology companies, we have an international business, and the strength of the dollar, the relative weakness of other currencies affects us directly because potential buyers in other countries just have less buying power. They are less likely to buy a product originating in the United States than from another country.

I understand that one of the key reasons for the strength of the dollar is that the U.S. Government borrows heavily to finance the deficit. This drives up the interest rates and consequently, the value of the dollar. Therefore, I would conclude that it's crucial to put a lid on those defecits. And I don't think that we're in a position to risk bringing in less revenue during a period when those deficits are so high.

The other concern that relates to the deficits is that the tax proposals divert attention from managing the budget and managing the operations of Government. One of the critical lessons that I've enjoyed learning as part of a small, growing company, establishing a new business, is that you have to focus almost single mindedly on accomplishing the most important tasks. And in my view, that's something that we really need to learn at the Federal level. I greatly appreciate the comments that Senator Kerry made this morning about focusing on making sure that we don't have a negative effect on the deficit situation by adopting tax reform proposals. In my view, we need to focus on balancing the budget, and that should take much higher priority than tinkering with the Tax Code, right now. We should view the work to cut the deficit as a critical first step toward implementation of a tax reform package.

Thank you.

[The prepared statement of Ms. Walkerman follows:]

TESTIMONY OF

BETSY J. WALKERMAN
Vice President - Finance and Administration
Aspen Technology, Inc.
Cambridge, MA
July 3, 1985

Senator Kerry, I appreciate your invitation to participate in this hearing. It's a refreshing opportunity to focus on policy issues of widespread importance.

I am speaking from the perspective of a small, but growing high-tech business. Aspen Technology is a leading supplier of state-of the art software to the process industries. Our technology allows companies that process any type of chemicals or materials to simulate the operation of their plants on the computer. This improves efficiency and often results in technological advances in the methods for producing commodities such as ammonia and plastics.

AspenTech is part of the oft-touted New England high-tech community. We try to be everything the magazines tell us we should be - tough, energetic, pragmatic and, above all, profitable. Although the Treasury Department is primarily interested in a slice of our profits, I assume that in asking for our comments and advice on the proposed tax reform packages this Committee would rather have a piece of our energy and pragmatism.

Let me give you my conclusion first. The concepts embodied in the three tax reform proposals are great, but the timing is wrong. Let me explain.

The concept of lowering the corporate and individual tax rates as a trade-off for reducing or deleting certain tax credits and deductions makes good sense.

In an academic sense, if we were starting from scratch, knowing what we know now, this is probably very close to what we'd choose. The reasons are as follows:

1. Setting the corporate tax rate relatively low, in the low 30% range, allows businesses to channel profits into further investment in growth.
2. Adopting a small number of corporate tax brackets with steep escalation keeps the tax burden on very small business somewhat lighter.
3. Having a "clean" calculation of income which is not artificially distorted by short depreciation schedules promotes fairness between capital intensive and labor intensive companies.
4. Providing no special tax credits allows the tax system to concentrate on even-handed revenue collection rather than economic and industrial policy.

In theory the tax rules would be less of a factor in peoples' economic decisions.

However, we are not in an ivory tower. We are not starting from scratch. The effect of incremental changes is important, and the tax proposals involve monumental increments. As with any change, there would be winners and losers and dislocation.

For business, the proposals send the wrong message. The message is don't invest - in either equipment or R&D.

We currently have two tax provisions that encourage investment in plant and equipment - the investment tax credit and accelerated depreciation schedules. Even at AspenTech, these provisions have allowed greater flexibility and more certain growth because they reduce the cost of leasing computers.

However, for AspenTech the reduction in the corporate tax rates would more than off-set the loss of the investment tax credit and accelerated depreciation. We would be one of the so-called winners.

To support the reforms on the basis that our own little company or our own little industry is a winner would be narrow-minded. The abolition of the investment tax credit and the longer depreciation schedules would remove a significant incentive for capital-intensive industries to invest in new equipment and modernization. AspenTech's customers are in capital-intensive industries. If the effect on them is to discourage investment, this will hurt us as well.

The abolition of the R&D tax credit, similarly, is the wrong message to send. Development of new technology is critical and provides promise for our economic future.

Thus, although the concepts embodied in the President's tax proposal are sound, we must take as a given that it would send strong negative messages to industry.

Negative messages and dislocation alone would not bother me. There is always going to be an initial price for improvement.

However, the proposed adoption of these changes in a six month period gives me pause.

When a proposal would cause negative impacts on certain businesses and economic priorities, the change should be made from a position of strength. This means, number one, during a strong economy and, number two, when we can afford to take the risk that unexpected results will occur. The most critical unexpected result would be that the new tax system generates less revenue than expected.

I am particularly concerned now that the Congressional Budget Office has concluded that the President's proposal is not revenue-neutral, but would result in even higher deficits than we currently have. This is not a risk we can afford to take.

Frankly, the budget and deficit are of far greater concern to me in the context of AspenTech's business than any of the changes proposed in the tax code. Like many other high tech companies, we have an international business. The strength of the dollar and the relative weakness of other currencies hurts us in the international marketplace because potential customers have less buying power. The U.S. government borrows heavily to finance the deficit. This drives up interest rates and increases the value of the dollar.

It is crucial that we put the lid on these budget deficits. We will not be in a position of strength until we do so.

Therefore, although the President's tax reform proposal is attractive, I conclude that the timing is wrong. It is diverting crucial attention from reducing the budget deficit and it comes at a time when we cannot take the risk that revenues will be lower.

One of the critical lessons that you learn in starting a business is to focus almost single-mindedly on the most important tasks. In my view, we need to focus at the federal level on balancing the budget, not on tinkering with the tax code. We should view the work to cut the deficit as the critical first step to implementation of a comprehensive tax reform package.

Thank you.

Senator **Kerry**. Thank you, Ms. Walkerman.

Mr. Neises.

STATEMENT OF JACK NEISES, PARTNER, CHARLES RIVER PARTNERSHIPS, BOSTON, MA

Mr. **Neises**. Thank you very much. I am Jack Neises, a general partner of the Charles River Partnerships, a large venture firm based here in Boston.

We've been in business over 15 years; we've made over $93 million of investments in approximately 115 high-technology companies throughout the country, but very much based here in New England. We have about $150 million under management, so therefore we have about $57 million more to invest in high Technology——

Senator **Kerry**. You don't want to tell us what that investment paid off, do you? [Laughter.]

Mr. **Neises**. Well, let me say this. We've had five partnerships, and many of our partners have been with us in all five. So I assume they like what they see, and they keep coming back for more.

At any rate, I'm on the board of seven high-technology firms throughout the United States, but most of them right here in New England. For 5 years I was on the board of the National Venture Capital Association, and I am now on the Visiting Committees for Entrepreneurial Studies at Cornell University.

Before joining Charles River as a venture capitalist, I was general manager of one of Dennison's divisions out in Framingham, MA and before that I was with Xerox in a number of jobs. I was an Air Force officer in Korea during the war.

My focus in being here today is to encourage entrepreneurship, that almost unique American phenomenon whereby someone with limited funds, usually a poor kid but well-educated kid who sort of dreams of doing something good, starts out with a large company and moves very well through those ranks, and then decides to jump out and do it on their own. And excellent ideas with the right nurturing can create some very powerful enterprises. We've seen a lot of them here in New England, and those are the ones that produce the private sector employment that we all prize so highly.

The reason these young companies do well is they've got technical superiority. They're able to compete in worldwide markets and really do a job exporting goods and services.

The central player in this whole drama is the entrepreneur, the innovator; not me—I'm just an enabler. We go on the board of directors, we provide money and some expertise, but the people that really make it happen are the ones that lay it on the line in terms of leaving the big company, abandoning the big salaries, usually, and all the wonderful fringes that go with being with a large company, and let the paycheck go, a second mortgage, whatever else it takes, and those are the people I want to talk about helping today.

Unfortunately, if you help them, you help me; and I'm sometimes called a fat cat but I guess that's one of the prices of doing it.

Our 15 years in the high-technology field, I think, have taught us several things. We've seen a lot of experimentations with the tax rates and capital gains, incentive stock options, and that 15-year perspective gives us some hard evidence as to what really is happening.

I think we feel most strongly that the differential tax rate for long-term capital gains and ordinary income should be a central part for whatever tax legislation is adopted. The administration is proposing, I think, a 17.5-percent tax on long-term capital gains as opposed to a 35-percent tax on ordinary income. Currently, it's 30 percent versus 50 percent. It's that differential that we prize so highly because it motivates people to leave the big company where they're making big salaries and go for the big win in terms of the capital gain.

We saw the experience back in the mid-1970's where the two rates were the same, roughly 50 percent and 50 percent, and as a result we had a hard time luring people out of the big companies to take the risks because if they took those big risks, the Government took half of the gain. The risk-reward relationship simply wasn't great enough to make them want to leave that warm cocoon of the large company. So what we say is, by all means, maintain this differential.

Another reason—and we think it's fair, because the people who take these risks, the long risks, and are willing to put money into something and are willing to defer the spending, should get better reward because they're the ones that make this economy go by creating these valuable companies.

Specifically, the kinds of investment that we're encouraging are the investments that directly into a company. Wall Street calls it primary funding; in other words, the corporation gets the use of that money. I'm not interested, necessarily, in supporting tax shelters where people get a writeoff of four times what they've invested, or any of those kinds of things. What we're looking for are hard dollar investments going into a productive company and stimulating that.

I think the other thing we're strongly in favor of in terms of an entrepreneurial tool, something that we saw tampered with by Washington in our 15-year period, is the incentive stock options. This is a powerful device for attracting, again, managerial talent to a promising but risky venture. In the late 1970's we had tax legislation that severely diminished the efficacy of stock options and incentives. We're now operating under a somewhat improved version of that ISO, or incentive stock option program, but I would urge the committee to consider incorporating a bipartisan measure introduced last year by Senators Packwood and Bentsen which would have modified the incentive stock option provision in three ways. They proposed that the spread between the exercise price and the fair market value would no longer be a tax preference item when computing your minimum tax. They second proposed that the sequential exercising rule be repealed, and third, they made a very important change, from our view—the rule now limits the granting of no more than than $100,000 of options per year to an outstanding manager. They are proposing that that be changed so that no more than $100,000 could be exercised in any one year. So you can't get rich quick, but you could certainly give someone a fat option to attract them away from the large comany. And those are excellent ideas. The text of that bill, I believe, is in S. 3089, Senator.

The ISO's are used by these young, innovative firms to award dedicated but usually underpaid employees. Betsy Walkerman can probably testify to that. During the firm's formative years you simply can't pay the salaries you would like to, so you've got to make it worth somebody's while to live on less; and the incentive stock option allows that to happen. At least you've got a chance for a carrot at the end, if you do well. And if you don't do well, you don't get it. It's a "meritocracy." and that's fine.

I understand that there's been some work done on the cost of this, and experts tell us that the Treasury would actually make money by adopting the ISO Program proposed by the Senators.

In summing up, I'd like to say that the hard data supports the contention here that when you have capital gains tax differentials—in other words, a greater reward for doing that, taking those risks and putting your money away for several years—you cause a lot of funds to flow from big institutions and places where it would not otherwise come by having that greater reward for doing so. I've submitted a lot of hard data here in my testimony which shows that jobs, in fact, are created; capital does, in fact, flow; and when you don't do these things—I also have shown the years when we didn't have the differential and when we didn't have the ISO Program, and companies weren't started, money didn't happen. That's all there. I'd like to go into those details if we had more time, but my bottom line is absolutely in agreement with fairness. I find it hard to think of a fair tax plan that still allows major oil companies to pay no tax. I don't see that because our little companies pay tax—as a matter of fact, they pay State tax on the first dollar they make. There's not even any carry-forward from the losses that they've had in years before. Only the Federal Government allows you to not pay when you have carry-forward. So our little companies are paying their fair share; I don't see why big companies can't do that.

I'd like to conclude by thanking you for the chance to represent the entrepreneurs, even though I'm not one. I think I know what they think.

[The prepared statement of Mr. Neises follows:]

STATEMENT OF JOHN T. NEISES
GENERAL PARTNER OF
THE CHARLES RIVER PARTNERSHIPS

BEFORE
THE SMALL BUSINESS COMMITTEE
OF THE
U. S. SENATE

July 3, 1985

OPENING STATEMENT
OF
JOHN T. NEISES

Before the
Small Business Committee of
the U.S. Senate

July 3, 1985

I am John T. Neises, one of four General Partners of The Charles River Partnerships, a large venture capital firm based in Boston. I was one of the founders of The Charles River Partnership and in 15 years we have made over $93 million of investments in 115 companies. I am now on the Board of Directors of seven high-technology firms spread throughout the United States. For five years I served on the Board of Directors of the National Venture Capital Association, and I am a member of a Visiting Committee on Entrepreneurial Studies at Cornell University. I am a member of the Board of Governors of the Harvard Business School Association of Boston and a Member and ex-President of the Norumbega Council, Boy Scouts of America, and hold a Silver Beaver award.

Before joining Charles River as a venture capitalist, I was General Manager for Dennison Manufacturing's Copier Division, and had been in various managerial positions, Director of Marketing, and Head of Planning with Xerox Corporation. I graduated from the University of Cincinnati, served in Korea as a 1st Lieutenant with the U.S. Air Force during the war and earned an MBA from Harvard in 1956.

Charles River has just finished raising its fifth fund of over $77 million. Our first four funds were approximately $6 million, $14 million, $25 million and $39 million, respectively. They have earned an above-average return for our investors. We still supervise active investments in all but our first fund.

Our focus in being here today is to encourage entrepreneurship, that almost unique American phenomenon whereby someone with limited funds, but excellent ideas, can create a large successful enterprise which creates many private sector jobs. The thrust of my experience in job creation has been mostly in the high-technology innovation area; for it is this superiority that allows a smaller company to compete on a worldwide basis and achieve market penetration and growth. The central player is the principal innovator or entrepreneur, surrounded by a team of other risk-takers who are well educated, extremely motivated professionals. The venture capitalist provides money and expertise in the form of Board membership but this is an enabling or facilitating function. Of very great significance is the regulatory environment and tax system that pervades these new ventures.

With our 15 years of experience in the high-technology field, we have seen various experimentations with ordinary income tax rates and a capital gains tax rate . We strongly feel that the differential between these two rates is almost as important as the actual rates themselves. The differential tax rate for long-term gains is now at a level where a highly-paid, successful executive is tempted to leave the security of a larger company and take the risk of earning a large capital gain because will be rewarded by getting to keep a large part of the appreciation. Thus, we would be strongly opposed to making the ordinary income tax rate and the long-term capital gains tax rate equal. We have experienced a period in which this equality prevailed and found it difficult to attract high-salaried executives from a more risk-free environment. In short, the government was taking too much of the pie.

Now a six month holding period is required for long-term capital gain. This is too short because no one can create a valuable enterprise in six months. What would make sense is to lengthen the period to one year, with added incentives for holding the investment for longer periods, to encourage people to forego spending and enter long-term investments to really create private sector employment. There might be a lower tax rate for a capital gain derived after three years.

The kinds of investment that should be encouraged by favorable tax treatment are those involving the infusion of equity capital into companies. Growth companies create jobs, improve national productivity and increase tax revenue. Equity capital is the lifeblood of growth companies and is sensitive to the capital gains tax rate and the differential between capital gains and that of other investment income. What I am talking about here is money that goes directly into a corporation, specifically called primary funding, as opposed to secondary stock transactions whereby money changes hands between two shareholders and does not go to the company.

We support incentive stock options as a tool for attracting managerial talent to promising but risky ventures. In the late '70s we had tax legislation that severely diminished the efficacy of incentive stock options. We are now operating under a somewhat improved version of the incentive stock option or ISO provision. Mr. Chairman, I would urge the Committee to consider incorporating a measure introduced last year by Senators Packwood and Bentsen, which would have modified the incentive stock option provision in three ways:

(1) The spread between the exercise price and the fair market value would no longer be a preference item when computing the minimum tax.

(2) The sequential exercising rule would be repealed.

(3) The rule limiting the granting of no more than $100,000 in options per year would be changed so that no more than $100,000 could be exercised in any one year.

The text of the bill is contained in S. 3089.

ISOs are used by young, innovative firms to reward dedicated but usually underpaid employees during the firm's formative years. ISOs are also a critical factor in attracting experienced senior management needed to assure the continued high-growth of these companies. This proposal could be adopted as part of the tax reform package at no cost. In fact, experts tell us the Treasury would actually make money by its adoption.

In closing, I would like to say that the hard data supports the case that the capital gains tax rate is critical to the flow of venture capital and to the success of innovative young companies which have provided the key to new private sector jobs in this economy. The availability of risk capital is dramatically affected by federal tax policy. The facts show there is a direct relationship between investments by venture capital firms and the maximum rates on long-term capital gains. In 1975, when the maximum capital gains tax was 49%, disbursements to entrepreneurial companies by venture capital firms dropped from $450 million in 1969 down to $250 million in 1975, a 45% decrease. Even more serious, new private capital committed to venture firms dropped from $171 million in 1969 to a mere $10 million six years later in 1975. See Table #1 attached.

The high capital gains tax rates beginning in 1970 disrupted the capital markets and dried up the flow of funds into venture capital firms. It was not until 1978, when the rate of tax on capital gains was reduced to 28 percent, that risk capital once again began to flow into the marketplace. Just a year before the 1978 Steiger Act, only $39 million in private capital had been committed to venture capital firms. In 1978, with the lowered rate, $570 million was committed, and disbursements to portfolio companies rose over 30 percent. The continuation of this lower capital gains tax rate enabled the industry to flourish and fund thousands of entrepreneurs. By 1983, some $4.5 billion in private capital was committed to venture capital firms. (See Table #2).

In addition to other effects, a high capital gains rate reduces the availability of capital for all corporations. When the capital gains tax rates increased in the late 1960s and throughout the mid-1970s, share values of issues dropped. The high capital gains tax rates increased the cost of capital for young companies and reduced returns on equity investments. The 1978 changes improved the market for companies to go public and raised additional funds through the issuance of stock. (See Table #3).

It is clear that lower capital gains tax rates will result in stronger economic growth, more tax revenues, and an acceleration of the rate of innovation. Low capital gains rates have had a dramatic impact on the growth of innovative companies. We offer the example of the electronics industry. From 1974 through 1977, the industry grew slowly, laboring under effective maximum capital gains rate of 49%. In 1978, when that rate dropped to 28 percent, the annual payroll jumped from $19.7 billion to $24.1 billion. That added an estimated $600 million in personal taxes paid -- in just that year. The industry continued to expand, receiving another boost in 1981 when the effective rate was dropped again to 20 percent. By 1983, payroll was estimated at $49.8 billion -- an increase of over 100 percent from five years earlier. Personal taxes paid increased accordingly to $7.5 billion. (See Table #4.) Also, we created 10 million jobs in the U.S. from '73 to '83, while the EEC lost jobs and Japan created only 2 million. (See Table #5.)

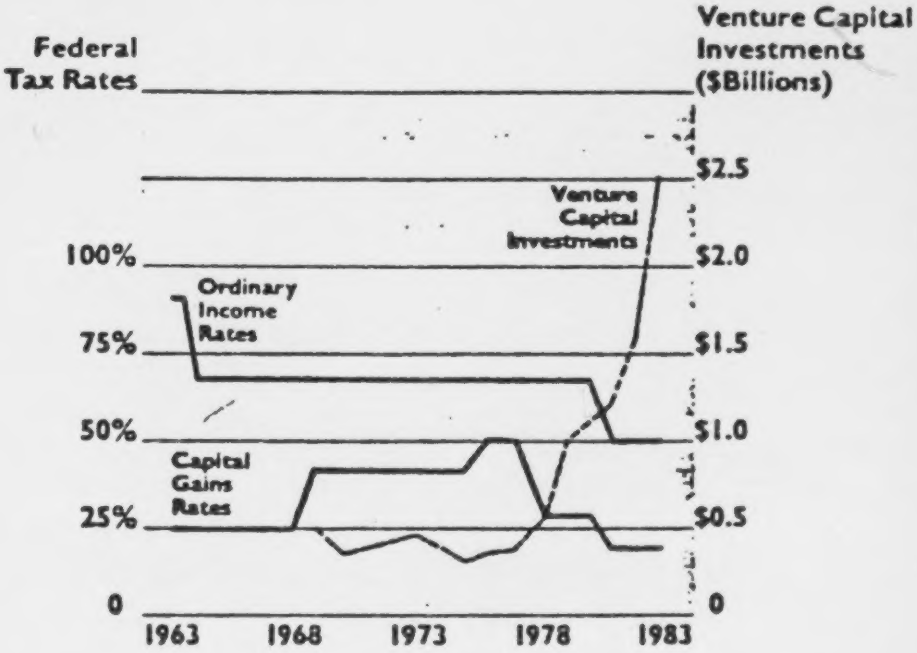
The hard data supports the case that the capital gains tax rate is critical to the flow of venture capital -- and to the success of innovative young companies. In the interest of encouraging the continuing development of growth companies with their job creating capability, we urge the Congress to support the Administration's tax proposal.

Thank you, Mr. Chairman, for the opportunity to appear before the Committee.

TABLE 1

Influence of Tax Rates on Investments

Relationship between direct investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains and ordinary income



SOURCE Syntrex Incorporated and Capital Publishing Company, 1983

TABLE 4

Venture Capital Industry

Estimated Venture Capital

($ Millions)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Size of Total Pool
1983	$ 4,500	$ 2,800	$11,500
1982	1,700	1,800	7,600
1981	1,300	1,400	5,800
1980	900	1,100	4,500
1979	319	1,000	3,800
1978	570	550	3,500
Capital Gains Tax Decrease			
1977	39	400	2,500-3,000
1976	50	300	—
1975	10	250	—
1974	57	350	—
1973	56	450	—
1972	62	425	—
1971	95	410	—
1970	97	350	—
Capital Gains Tax Increase			
1969	171	450	2,500-3,000

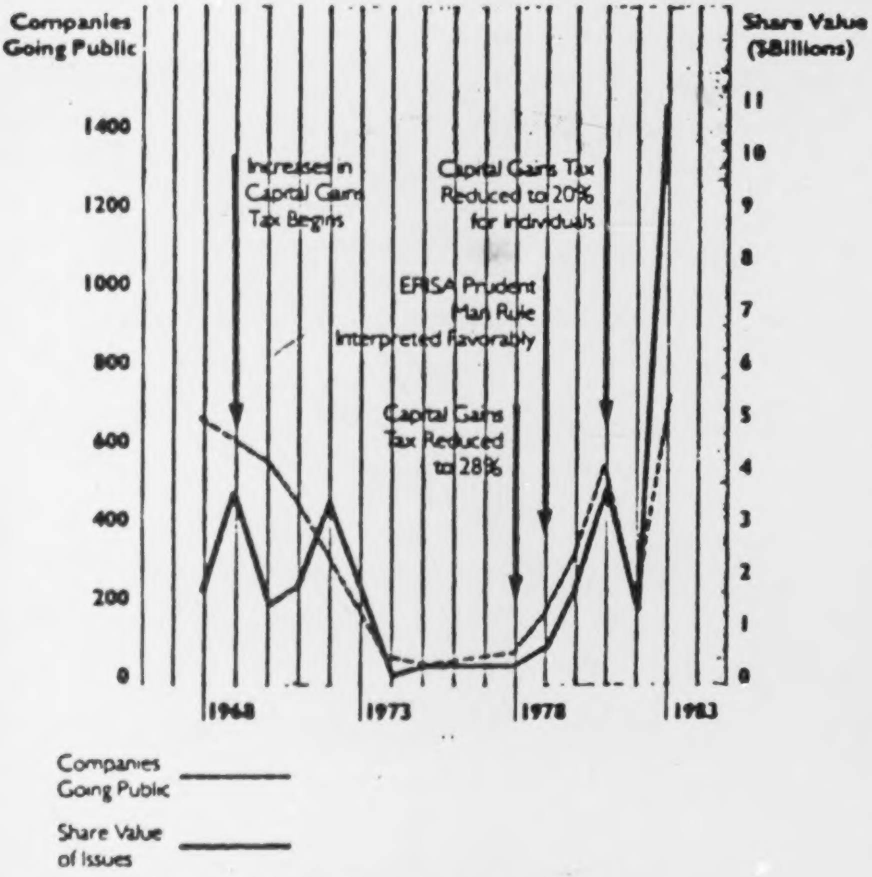
SOURCE: *Venture Economics* August 1984

TABLE 3

Policy and Rules Changes

Effect on Flow of Public Offerings

(Current Dollars)



SOURCE: (For Figures Only) *Investment Dealers' Digest,* 1/17/84

TABLE 4

SIZE OF U.S. ELECTRONICS INDUSTRIES, 1974-1983

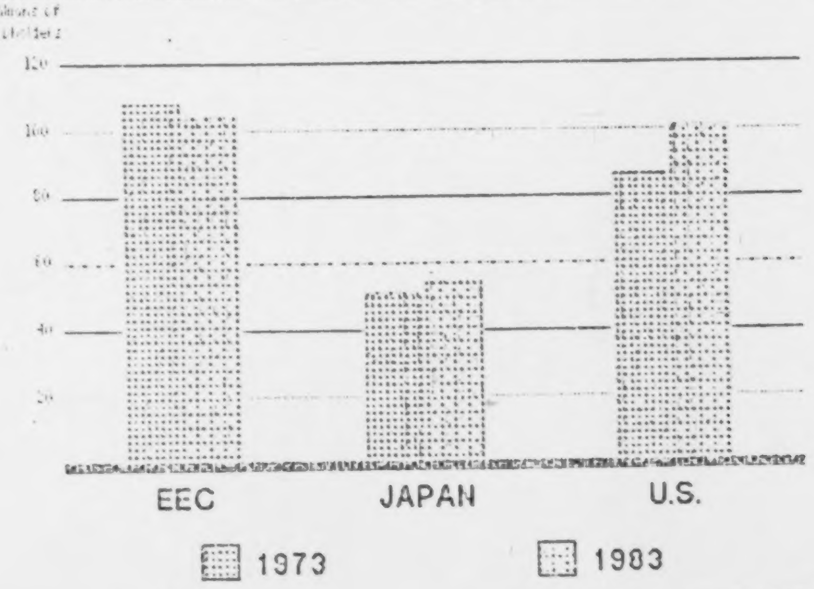
Years	Number Employees	Annual Payroll (billions)	Estimated Personal Taxes Paid** (billions)	Capital Gains Effective Maximum Tax Rate
1974	1,440,000	$ 15.8	$ 2.4	49%
1975	1,300,000	15.9	2.4	49
1976	1,300,000	17.5	2.6	49
1977	1,430,000	19.7	3.0	49
1978	1,570,000	24.1	3.6	28
1979	1,790,000	29.3	4.4	28
1980	1,960,000	35.1	5.3	28
1981	1,970,000	39.8	6.0	20
1982	2,070,000	43.5*	6.5	20
1983	2,280,000	49.8*	7.5	20

* Data for 1974-1981 are AEA estimates based on data published in County Business Patterns. Data for 1982 and 1983 are AEA estimates based on data supplied to AEA by the Bureau of Labor Statistics. Comparable data is not available for years prior to 1974. The 1983 employment total includes selected service categories not included in prior years.

** Assumes average effective personal tax rate of 15%.

TABLE 5

CIVILIAN JOB CREATION



Source Citicorp Information Services

Senator KERRY. Thank you very much, Jack.
Professor.

STATEMENT OF PROF. PAUL McDANIEL, BOSTON COLLEGE SCHOOL OF LAW, NEWTON, MA

Professor McDANIEL. Thank you, Senator. I have prepared a formal statement which can be included in the record, and I will just summarize that statement in my remarks here.

In the formal statement I made some comparisons of the major tax reform proposals that have surfaced—the Bradley-Gephardt bill, the Kemp-Kasten bill, what has been known as Treasury I, and the President's proposals made this past spring.

Let me comment on the provisions and compare them from the standpoint of some of the broad objectives that you identified in your remarks.

First, let me address the President's proposals from the standpoint of the deficit issue and purported revenue neutrality of the measures. I haven't run any calculations myself, but there are two reasons that, it seems to me, make abundantly clear that the President's proposals cannot be revenue-neutral in the short term or in the long term. They will not be revenue-neutral in the short term, at least if Congress follows past practices, because of the lack of transition rules with respect to two of the major items, namely, the repeal of the investment credit and the changes in the depreciation rules. Congress, in the past, when it has changed those provisions, has always provided that the existing levels of depreciation and investment credit will be available for binding contracts entered into prior to the effective date of the change. There is no such provision in the President's proposal; it simply proposes to turn off the investment credit and change the rules as of January 1. Congress can do that, but if you do it's going to produce some fairly severe economic distortions by piling up investment at the end of 1985 and foregoing it in 1986, I would think.

If, on the other hand, you provide the typical kind of transition rule, then probably the President's proposal is in deficit immediately over a 5-year period, I would guess, somewhere in the neighborhood of $40 billion. But it's a substantial amount.

The reason that the President's proposal can't be revenue-neutral in the long term is because of the provision to index depreciation for inflation. While the proposal shows some increase in corporate taxes in the next few years, the changes in depreciation schedules and the indexation of depreciation, when you start the miracle of compounding, I think, wil convert this bill into a major revenue loser as compared to present law, beginning somewhere 5, 6, 7 years out. These are matters that I think the committee needs to explore very carefully with people who are more trained in economic analysis and budget estimating than I am. But just looking at it, it seems to be fairly clear that it can't possibly meet the revenue neutrality criterion.

The second major theme that has emerged in the various tax proposals insofar as they affect business has been to change from a system in which heavy subsidies are provided to particular kinds of activities or particular kinds of business through the tax system to me in which investment decisions are neutral as to where capital will go, that is, let capital move where it will produce the highest yield from economic and market forces rather than to where the particular activity or asset is subsidized heavily by the tax system.

This theme was especially marked in Treasury I and also is a point of emphasis in the Bradley-Gephardt approach. It really undergirds their proposals to eliminate most of the preferences that are provided through the tax system. Treasury I, as I say, and Bradley-Gephardt carry that philosophy out fairly throughly; the President's proposals retreat from it rather sharply and continue to use the tax system to provide incentives or cost-sharing for particular kinds of activities. Whether one wishes to do that or not is a matter of whether or not we think Federal funds should be expended to encourage particular kinds of activities or investments over others or not and, if so, whether those funds should be provided through the tax system.

Another point with respect to neutrality that should be noted concerns the position of U.S. businesses vis-a-vis foreign businesses. All of the proposals provide that the base of the corporate tax will be broadened, and the rate will be dropped to 33 percent. It's important to keep in mind that that rate is dropped to 33 percent not just for U.S. corporations, but for foreign corporations that come into the United States and set up domestic subsidiaries. We will now, with a 33-percent tax rate, be a relative tax haven compared to most other industrialized countries in terms of their corporate tax rate. And one thing that I think ought to be looked at is the question of the impact of this inducement for foreign businesses to locate in the United States and compete here, given the fact that our rate will now be 33 percent—or would be 33 percent—as compared, for example, to a 56-percent rate in Germany, 52-percent rate in the Netherlands, and the like.

The third theme that runs through these various proposals is simplification, and that is closely tied in Bradley-Gephardt and Treasury 1 with the comprehensive base broadening. I would say that the President's proposals probably fail almost totally on this ground; I think that for business and investment, the net is a more complex system than we have at the present time. There are two reasons for that conclusion. One is the retention of the preferential rates for capital gains, which itself is a source of major, major complexity in the existing system. Any proposal that retains the differential cannot make any serious claim to simplify the income tax system.

The President's proposals compound this difficulty by providing, beginning in 1991, an option to index the basis of capital assets for depreciation and gain or loss computation. Now, this is called an option, but of course it won't be an option; it will be mandatory for everybody to maintain the kinds of records necessary to index basis because, given the option, you've got to make both computations before you can find out which way you're going to pay the least tax. So in fact, while it's called optional, it is not.

Indexation of basis for inflation is a very, very complicated matter and is going to require a large amount of bookkeeping and recordkeeping, both by Government and by taxpayers. And when you add that complexity on top of all of the difficulties that exist at the present time, as taxpayers try to get themselves on the capital gains rather than the ordinary income side of the line, complexity has increased by a very, very substantial amount.

The President's proposal to index inflation also has another impact on the simplification and equity issues, and that is that it's going to enhance tax shelters and increase the opportunities for what is called tax arbitrage that exist at the present time. Let me give you a simple example of what will happen under the President's proposals.

The President proposes to index the basis of assets for inflation. The proposals, however, do not index the debt side, so that the taxpayer can borrow money and buy an asset; the asset will be indexed for inflation, but he will be able to deduct interest as if there were no inflation. Now, notice what happens. You buy an asset for $100. Inflation goes up by 10 percent after 1 year. You have borrowed $100 to buy that asset at 10 percent, paying 10 percent interest. At the end of year one, you sell at $110. No gain or loss is recognized because you have indexed your basis to increase to $110. But on the other hand, you have been allowed to deduct the $10 interest that you paid on the transaction. Thus, in a transaction in which there is no gain or loss economically, this taxpayer is going to walk away with $5 from the Treasury Department. And this result is going to run through the whole system if you adopt the President's proposals. The result will be the same for indexing depreciation in tax shelter transactions. It's just that it the mechanics are a bit different. Congress really cannot, in my view, index basis and not index debt. You can do either one or the other. Treasury I indexed everything, and I think that was an acceptable approach. Bradley-Gephardt indexes nothing, and that is an acceptable approach. But what isn't acceptable is the President's proposal.

Let me conclude by observing that, on this question of providing incentives through the tax system, the notion of revenue neutrality that undergrids Treasury I really is a view that we should not finance anything through the tax system. That is, all of these provisions should be repealed or cut back sharply because that is the way that the tax cuts can be financed. That is a meat ax approach to the problem and, as I say, undergirding it is the assumption that the Federal Government shouldn't be spending any money to support particular kinds of activities. I think that assumption has to be looked at carefully. It may be for example, that the Treasury I reliance on market forces will, in fact, ensure the preservation of historic structures; and then again, maybe not. But what we do know is that at the present time, the only method of Federal support for rehabilitation of historic structures is provided through the tax system.

I really think there's no easy way to approach tax reform except to take a hard look at each one of those tax expenditure provisions and ask one-self the question, is there a need for Federal funds in this area? And if so, do we best provide it directly or through the tax system?

Thank you.

[The prepared statement of Professor McDaniel follows:]

TESTIMONY OF PROFESSOR PAUL McDANIEL, BOSTON COLLEGE SCHOOL OF LAW

I appreciate the invitation of the Committee to testify in its hearings on tax reform and to provide an evaluation of alternative tax reform proposals that have been prepared by the Administration and by members of Congress.

I am Professor of Law at Boston College Law School and am Of Counsel to the law firm of Hill & Barlow, Boston, Massachusetts. In my testimony today, I am not representing the interest of any client, institution or group.

Four major proposals for comprehensive tax reform have come to dominate the legislative scene: The proposals of the Reagan Administration contained in the "President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" (the "President's" proposals); the proposals of the Treasury Department contained in its documents "Tax Reform for Fairness, Simplicity and Economic Growth" (the "Treasury 1" proposals); the Fair and Simple Tax Act (the "FAST" tax proposal), introduced by Representative Kemp and Senator Kasten; and the Fair Tax Act (the "FAIR" tax proposal), introduced by Senator Bradley and Representative Gephardt. In my testimony I shall compare and evaluate the four proposals in light of their avowed objectives to achieve greater tax simplification and tax equity and to provide more efficient and effective incentives for work and savings. In addition, I shall indicate how the various proposals should be evaluated from the perspective of spending objectives of the Government.

In very broad terms, the President's, Treasury 1, FAST and FAIR tax proposals share a common approach. Each proposal adopts what has traditionally been referred to as a "base-broadening" approach through the elimination of numerous special exclusions from income, deductions, and tax credits. Each proposal also approaches the quite distinct question of tax rates by applying all of the revenues gained from the base-broadening revisions to reducing both the marginal rates presently applicable to individuals and the number of rate brackets. On the corporate side, base-broadening revenues are likewise devoted to rate reductions, although Treasury 1 and the President's proposals use some of these revenues to fund individual tax cuts. It is helpful to discuss separately the issues posed by the proposed changes in _tax rates_ and the issues posed by the proposed changes in the _tax base_.

THE TAX RATES

There is no single set of rates which is normative for an income tax system. Instead, the design of a rate structure is a matter to be determined from broad political objectives such as the amount of revenue required, whether single persons and married persons should be subject to the same or different rates, whether two-income couples should be taxed the same as one-income couples, whether adults with dependent children should be subject to the same rates as adult taxpayers without dependent children, etc.

The answers to these questions rest on an assessment of broad value judgments rather than on tax theory.

Although each proposal has been heavily influenced by calls for a so-called "flat" tax rate, each adopts a progressive rate structure. Each contains four rate brackets, although the rates themselves and the levels of income to which they apply are different. Each proposal provides a zero rate of tax for different amounts through a combination of the zero bracket amount and personal exemptions. The President's and the Treasury 1 proposals provide three positive rates of 15, 25 and 35%. The FAIR tax proposal provides three positive rates of 14, 26, and 30%. Nominally the FAST tax proposal calls for a single 24% positive rate, but in fact it reflects rates of 20, 28 and 24%.1/

The various rate structures in the four proposals pose several distinct questions.

The first question to address is the point at which positive tax rates will begin. In the United States, the policy for some years has been to begin positive tax rates at the point at which each family unit's income exceeds the officially established poverty level. The President's proposals quite explicitly reaffirm this policy. His proposals achieve this objective by increasing the personal exemptions and the zero bracket amount. The others generally are in accord although the mix of personal exemption levels and zero bracket amounts varies.

One group of taxpayers, single individuals, is not fully protected under the President's proposals; that is, some single individuals will experience tax liability with income below that officially established as the poverty level for single persons. This gap was explained on the basis that fully exempting single persons with poverty-level incomes from taxation would increase the marriage penalty. The policy of exempting all poverty level individuals from income taxation could be pursued and the marriage penalty problem solved by continuing the existing two-earner

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1/ See Burton, Major Tax Reform Proposals at a Glance, 23 Tax Notes 1095 (1984); Staff of Joint Committee on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform (Feb. 28, 1985). The rather peculiar rate structure that is embodied in the FAST tax proposal is a result of a provision that grants a special reduction equal to 20% of employment income up to the social security wage base. As a result, the real marginal tax rate for incomes under the social security wage base is about 20% (rather than the 24% rate specified in the nominal rate structure). Above the social security wage base figure, the special deduction is phased out at 12 1/2% rate. Accordingly, in the phase-out range, the marginal tax rate is about 28%, rather than the 24% nominal rate.

deduction (or an alternative tax credit). The President's proposals, however, include a repeal of the two-earner deduction in the ground that the breadth of the tax brackets mitigates the marriage penalty to a point where retention of the deduction in no longer justified. In my view, the policy behind exempting poverty level individuals from taxation should be dominant. Establishing the zero bracket amount and personal exemptions at levels which ensure achieving that objective for all family units of whatever composition should thus be the first step. The Committee then can determine the nature and extent of the resulting marriage penalty problem. If that problem in turn is extensive enough to warrant relief, even under the rates schedules contained in the various reform proposals, a limited form of two-earner deduction (or tax credit) should be able to be developed which would alleviate the marriage penalty problem at an acceptable revenue cost.

A second consideration in the design of a rate structure is to settle upon the number of brackets of income that will be used. While much is made in the President's proposals, and in the other proposals as well, of the simplification achieved by reducing the present fourteen brackets to three, in fact very little simplification would result from this action for most individuals. The vast majority of individual taxpayers determine their tax at the present time from tax tables. They will continue to determine their tax in the same manner under each of the reform proposals. Whether those tables reflect fourteen brackets or three brackets or five brackets would seem largely irrelevant from a simplification standpoint. It is possible that some simplification would be achieved in that the wide range of income covered by the brackets might make some income splitting devices less attractive within a family unit. However, it seems likely that there will still be an impetus for a 35% bracket parent to try to shift income to a 15% bracket child, using, for example, the President's proposed rate structure.

All proposals do achieve significant simplification by virtue of increasing the zero bracket amount. One of the functions of the zero bracket amount is to set a floor on the deductions for allowable itemized personal costs. Raising that floor will mean that, at the margin, some taxpayers who presently itemize deductions will shift to becoming non-itemizers. For this group of taxpayers, the tax system will be more simple than at present. In addition, the removal of poverty level individuals from the tax roles by means of the increases in the personal exemptions and the zero bracket amount will also achieve, by definition, tax simplification for those individuals.

Another set of policy issues in the rate structure is the degree of progression which the rate structure should reflect and the top marginal rate that should be imposed on income. The four proposals share the view that the top marginal rate of 50% should be sharply reduced, with the top rates in the proposals ranging from 28% to 35%. In all proposals, the top marginal rate is reached at middle income levels, at least by present standards. Thus, for example, a married couple filing a joint return will hit the top 35% marginal rate under the President's proposals at $70,000 of taxable income. Under present law, that couple does not reach the top marginal rate of 50% until taxable income exceeds $162,400. Single persons would hit the top 35% rate at about $40,000 of taxable income.

All four major reform proposals adopt progressive rate structures and, therefore, presumably are grounded in traditional ability to pay principles that have supported arguments for a progressive rate schedule. However, each proposal is open to serious question as to whether the rate structures proposed are consistent with ability to pay principles. For example, under the President's proposals, a family with $5,000 of taxable income is deemed to have exactly the same relative ability to pay tax as a married couple with over five times that income; both families will incur a marginal rate of 15%. A married couple with $35,000 of income is deemed to have the same relative tax paying capacity on income above $29,000 as does a couple with double that amount of income. And, finally, a married couple with $75,000 of taxable income is deemed to have the same relative tax paying capacity as a married couple with $1 million of income. The other comprehensive tax reform proposals reflect similar patterns. Thus, under the FAIR tax proposal, a married couple with $10,000 of taxable earned income will pay the same 14% marginal tax rate as will a married couple with $40,000 of taxable earned income. Under the FAST tax proposal, a married couple with $10,000 of wage income and a married couple with $45,000 of wage income will each incur the same marginal rate. I suggest that these results are not more fair or more equitable than the present rate structure. While it is important to focus on horizontal equity issues involved in properly defining the tax base, it is equally important to keep in mind that vertical equity issues have played and do play an important role in the notion of fairness of an income tax system. I urge that Congress seriously consider at least one bracket of income using a marginal rate higher than 35%.

The President's proposal to reduce the top rate to 35% is on even less firm ground than the other three proposals. This is because the President's proposals retain the preferential treatment for capital gains. Under the other three proposals, there is some justification for reducing the top marginal rate to 35% for the highest income Americans if all income is going to be taxed alike, i.e., capital gains will be treated like ordinary income and subject to regular ordinary income rates. With the decision of the President to retain the preference for capital gain rates, there is no justification at all for dropping the top marginal rates to 35% for the highest income Americans. If the Committee decides to adopt the President's proposal to exclude 50% of long-term capital gains from gross income, then as a matter of fairness, it should retain the 50% marginal tax rate at present levels of taxable income. While the President's proposal for a minimum tax will subject some capital gains to a 20% rate, in lieu of a 17.5% rate, the small revenue gain from the minimum tax proposal indicates that the impact will be very slight indeed. Under these circumstances, and given the fact that capital gains constitute a very high percentage of the economic incomes of those with incomes above $200,000, retention of the present 50% marginal rate bracket is required by notions of ability to pay.

Lower top marginal rates are sometimes defended on the basis that they will provide greater incentives to work and saving than is true of the present rate structure. These assertions are still the subject of considerable debate among economists. Lower marginal rates will leave taxpayers with greater amounts of disposable income, but whether taxpayers will use that increased income for personal consumption or for savings cannot definitively be answered. Moreover, if a taxpayer is earning a satisfactory amount of income at the present time under the present rate structure, there is little reason to expect that he or she will work harder when lower marginal rates will produce greater after-tax income with the same level of work.

In sum, each of the four major tax reform proposals appears to reduce to some degree the level of complexity inherent in a progressive rate structure. Each satisfies the policy requirement that poverty level individuals by and large should be exempt from federal income tax. In my view, all are defective in assuming that a three-rate structure, with a maximum 35%, is more "fair" than the present rate structure. And, as discussed above, in this respect the President's proposal is distinctly inferior to the other three in its retention of preferential treatment of long-term capital gains.

A final note should be added with respect to the matter of tax rates. If Congress should adopt the suggestion that a rate bracket above 35% is required by the ability to pay principle, then it will correspondingly have to consider the rate applicable to corporate income. It is undesirable to have the maximum corporate rate significantly lower than the maximum individual rate. Thus, it may be necessary to employ a top corporate rate higher than the 33% rate proposed by the President. Failure to do so would present too great an opportunity to shelter income by the corporate vehicle.

THE TAX BASE

All four major tax reform proposals repeal numerous special exclusions from income, deductions, and tax credits presently in the Internal Revenue Code to achieve non-tax objectives. In this section I will examine selected major components of the various proposals insofar as they seek to broaden the tax base.

1. Capital Gains. The Treasury 1 and FAIR tax proposals would repeal the preferential treatment of capital gains and apply the regular rate structure to that form of income. The President's proposal, beginning in 1991, provides an option to holders of capital assets: they could elect to index the basis of their assets for purposes of computing gain, but if they did so, they would not be entitled to preferential treatment on long-term capital gains; alternatively, they could take the preferential treatment for long-term capital gains but the amount of the gain would not be indexed for inflation. The FAST tax proposal provides treatment for capital gain similar to that the of Administration.

The elimination of the distinction between capital gains and ordinary income would represent both a major tax simplification and a significant step toward greater tax equity. Indeed, no proposal that retains the distinction between long-term capital gains and ordinary income can make any serious claim to tax simplification or tax equity. Elimination of the preferential treatment would permit the repeal of some of the most complex provisions in our individual, corporate and partnership taxation rules. Correspondingly, the time tax advisors devote to structuring transactions to come under the definition of capital gains could be spent in economically more productive pursuits. The burden on courts would also be reduced as litigation over what does and what does not qualify for capital gains would be eliminated.

From the standpoint of tax simplification, the President's proposals with respect to capital gains in many respects represent the worst of all worlds. All of the complexities of the present distinction between capital gain and ordinary income would be retained. In addition, after 1991, all taxpayers with capital assets would be required to maintain the records necessary to adjust basis for inflation and to undertake alternative computations since, otherwise, they would not know which of the two options provided to them would be the most financially attractive. Treasury 1 and the FAIR tax proposal, on the other hand, would eliminate all of the complexity of the capital gains-ordinary income distinction. It is true that Treasury 1 introduced the complexities that would be required by any inflation adjustment proposal but that trade-off seems a reasonable one under the circumstances. What is not reasonable is to retain the present capital gains tax preferences, as is done in the case of the President's proposals and add a new level of complexity on top of the present system by permitting (practically requiring) taxpayers also to compute gain on an inflation adjusted basis.

It is important to remember that capital gains enjoy several different preferences under the present system. In the first place, gains are taxed on a realization basis only. This means that a taxpayer in effect is given an interest-free loan for the tax on the accrued gain that takes place each year until a sale or exchange takes place. Second, no interest is charged on this loan. Third, preferential treatment is given in the form of lower rates if even when a sale or exchange takes place, thus resulting in a complete forgiveness of part of the loan. Finally, if an asset is held until death, the gain is forever exempted from income tax. Against all of these advantages is the disadvantage that the capital gains tax, when it is imposed, is imposed on nominal rather than real gains, i.e., the basis of capital assets is not indexed for inflation. Offsetting this negative, however, is the positive that taxpayers who borrow to purchase capital assets likewise are not required to report the inflationary gains they realize as they repay debt with inflated dollars.

The Treasury 1 and FAIR tax proposals would retain the benefits of the realization principle and the non-taxation of gains at death. Treasury 1 proposes to index not only capital assets but also debt as well and thus achieves neutrality in this respect. The President's proposal eliminates none of the benefits presently accorded to capital assets, permits indexation on the asset side, but does not require indexation of debt.

Permitting indexation of capital assets without requiring the indexation of debt is a fatal flaw in the President's proposal. A simple example will illustrate the point. Suppose a taxpayer invests in an asset at a cost of $100. He holds the asset for one year during which time the rate of inflation is 10%. He has borrowed the $100 to acquire the asset at a 10% interest rate. At the end of the year, under the President's proposal, the taxpayer could adjust the basis for inflation, sell the asset for $110, and realize no gain or loss. On the other hand, he would be entitled to deduct the full $10 of "interest" against other income even though obviously he has incurred no interest cost in real dollar terms. In effect, a 50% bracket taxpayer would realize a $5 profit from the tax system in a transaction in which no economic gain or loss was realized.

The President's proposals do take a step in the direction of the Treasury 1 and FAIR tax proposals in that Section 1231 would be repealed. That reform is long overdue and will produce some simplification as the result of the elimination of the need for rather complex recapture provisions of present law. However, as noted below, the ability to index the basis of these assets for depreciation without being required to index the interest paid on debt to finance the depreciable property will provide a real bonanza for the tax shelter industry. That is to say, when the asset that a taxpayer has required by borrowed dollars is a flow of depreciation deductions, the benefit of non-indexation of debt is the same as in the case of non-indexed debt used to acquire a share of stock.

I recognize that the proper indexation of debt for inflation is a complex matter. The proposal in Treasury 1 had its defects, but it represented an attempt to provide a practical second-best approach to the problem. It may be that present learning does not give us to a clear answer as to the proper treatment of debt in an inflationary economy. If that is the case, then the indexation of the basis for assets for inflation should be deferred until we have found a workable solution for the debt side of the transaction. Indexation of asset basis only will simply introduce into the economy a different set of distortions than we experience at the present time from the failure to index both debt and assets. It is debatable whether that set of distortions is preferable to those experienced under the present rules. Given the extremely favorable depreciation rates proposed by the President, it is likely that the new situation would be worse than present law, as will be discussed below.

Finally, if indexation is to be allowed for capital assets, it would seem absolutely essential that Congress impose a tax on accrued gains of property held at death. With indexation, imposition of a tax on gains at death can be implemented as a practical matter since all taxpayers with capital assets will be required to have the necessary records to determine whether to exercise the option that would be provided by the President's proposals. The imposition on tax on gains at death would eliminate the lock-in effect that is presently experienced as elderly taxpayers hold assets until death in order to obtain the benefit of the step-up in basis.

With respect to the treatment of capital gains, I would therefor submit the following recommendations to the Committee:

-- The proposals in Treasury 1 and FAIR tax to treat capital gains like ordinary income are far superior to the President's proposals.

-- If preferential treatment for long-term capital gains is to be retained, then indexation of the basis of those assets for inflation should not be permitted.

-- If indexation on the asset side is to be considered, debt must also be indexed for inflation to prevent new investment decision distortions and inequities; if a workable method of debt indexation cannot be developed at the present time, then indexation on the asset side should be deferred until the debt side of the equation can be resolved (as FAIR tax does).

-- If preferential treatment of capital gains is to be retained and especially if those assets may be indexed for inflation, then it is imperative that gains realized at death be subject to taxation.

2. Depreciation. Treasury 1 proposed to replace present depreciation rules with a system designed to correspond closely with economic depreciation. The FAIR tax proposal would adopt a modified version of the former ADR system and also is intended to bring tax depreciation closer to economic depreciation than is the case at present. The FAST tax proposal in general adopts a system that approximates immediate expensing. The President's proposal revises the present depreciation scheme by creating six classes of assets with somewhat longer lives than at present but permitting indexation of the basis of assets for depreciation. As noted above, the President's proposals, while permitting indexation of the tax base for depreciation purposes, do not require indexation of the debt with which those assets may have been acquired. In addition, the President's proposals require corporations to recapture of a portion of accelerated depreciation taken between 1980 and 1986 to prevent a windfall for taxpayers that took accelerated depreciation deductions against higher rate brackets while restoring the benefits of that depreciation at lower rates.

In establishing the rules for the treatment of income from capital, Congress should have as its guiding principle the proper measurement of net income so that investment decisions among assets will be made on the basis of their true economic yield, rather than on the basis of subsidies granted through the tax system. Only Treasury 1 achieves this objective. The FAIR tax proposal is preferable to present law but is not as comprehensive as Treasury 1. Both the President's proposals and the FAST tax proposal are seriously defective in achieving this objective.

As the President's own data reveal, the present value of depreciation deductions for virtually all classes of assets is greater under the President's proposals than under ACRS and that differential grows dramatically as inflation increases. The problem with the depreciation system since 1981 has not been that the benefits of ACRS are not generous enough. Quite the reverse. The problems that have been created by ACRS result directly from the fact that it contains such a heavy subsidy element and so distorts investment decisions. As the Treasury's own figures show, the adoption of the President's proposals will simply magnify this problem and, when combined with the benefits of leverage, may produce greater investment distortions than we have under existing law.

The President's proposals implicitly assume that a subsidy should continue to be given for investment is depreciable assets. Without stating why, the President has proposed that the best form of subsidy is through accelerated depreciation rather than through the investment credit or a direct subsidy program. The question raised by the President's proposals is which of the methods of providing an investment subsidy is the most effective in terms of maximum benefit for revenue cost. A second question is whether methods can be devised by which tax policy concerns with respect to the investment subsidies can be eliminated if it is decided to continue to run a subsidy through the tax system either in the form of accelerated depreciation or the investment credit.

Although the demands of tax simplification and tax equity require the adoption of economic depreciation, objectives of tax policy can be accommodated to either accelerated depreciation or the investment credit. That is to say, tax inequity can be avoided even if it is decided to provide one of the two forms of subsidy through the tax system. The appropriate tax responses that the Committee should consider are:

a) If the subsidy is to be provided in the form of accelerated depreciation, it should be recognized that the taxpayer is being granted a loan from the Government in the early years of the ownership of the asset. That loan is repaid in the later years as accelerated depreciation falls below economic depreciation. The appropriate tax policy response if this form of investment subsidy is adopted is to impose an annual interest charge on the tax that would have been paid had economic depreciation (or a reasonable equivalent thereof) been employed. The technique here is similar to that involved in the case of interest-charge DISCs. This treatment is entirely consistent with normative income tax rules. That is, receipt of a loan in and of itself does not represent income to the taxpayer. However, income does result if the taxpayer is not charged a market rate of interest. Accordingly, tax equity objectives can be achieved if an interest charge at the applicable federal rate is imposed on the loan that is effected through accelerated depreciation.

b) If the investment credit is selected as the more appropriate form of investment subsidy, then the amount of the credit should either be included in income in the year the credit is taken or the basis of assets acquired which qualify for the investment credit should be reduced by the full amount of the investment tax credit (rather than one-half the amount of the credit as is true at the present time). In this way, under either alternative, the amount of the credit will be included in income of the taxpayer, immediately or over time, just as would be true in the case of a direct grant from the Government. As a result, tax equity concerns can be adequately addressed. At the present time, the proper tax treatment is provided only in the case of the investment credit allowed for the rehabilitation of non-historic structure buildings.

At this point I should note that in my view the Treasury proposal to recapture the benefits of 1980-1986 accelerated depreciation is entirely sound. As discussed above, taxpayers received an interest-free loan when they took accelerated depreciation between 1980 and 1986. The value of that loan was a function of the taxpayer's tax rate, typically 46% for corporations. The tax loan was to be repaid when depreciation deductions fell below economic depreciation. As long as the taxpayer's rate is the same at the time of repayment of the loan, the full amount of the loan would be recovered by the Government. Under the President's proposal to reduce the top corporate rate to 33%, the tax loans taken out through accelerated depreciation between 1980 and 1986 would not be recovered in full by the Government; instead, a part of that loan would in effect be forgiven because the loan repayment would only be made using a 33% rate whereas the loan was taken out by using a 46% rate. It is to prevent this loss of 40% of the loans that were made through accelerated depreciation that the President's recapture proposal is designed to address and it is an appropriate response to the problem.

3. Dividends Paid Deduction. The President's proposals include a deduction for 10% of dividends paid to shareholders by corporations. Treasury 1 had provided a 50% deduction for dividends paid. The FAIR and FAST tax proposals had not included dividend deductions. The President's proposal appears to be a token in the direction of integration of corporate and personal income taxes. At a 10% level, the complexity engendered by the provision is simply not worth any perceived foot in the door for subsequent more complete integration action. The deduction can only be given for dividends paid out of taxable income and thus a new account must be created for which records must be kept in order to determine whether dividends qualify or do not qualify for the dividends paid deduction. Moreover, as the President's proposals indicate, the availability of the deduction with respect to dividends paid to foreign shareholders raises serious questions. The President proposes a 3.3% compensatory withholding tax to take into account the fact that many foreign shareholders will not pay tax to the United States on dividends qualifying for the special deduction. The Treasury also notes that this could create serious problems under tax treaties for the United States. It is really quite pointless to require the Treasury to engage in a whole round of tax treaty negotiations on the basis of a 3.3% withholding tax rate. Where countries have adopted more full-blown integration systems, it is clear that they have a decided interest in the question of whether they will grant their imputation credit to U.S. shareholders. The notion that they would accept as a fair trade an agreement that the U.S. would not impose a 3.3% withholding tax if they give the benefit of their imputation credit to our shareholders is naive at best. Moreover, the Treasury proposals do not discuss dividends paid to tax-exempt organizations. Are dividends paid to tax-exempt organizations to qualify for the deduction? If so, upon what theory? If not, how will the exclusion be administered?

In sum, the President's proposal for 10% dividend deduction raises all the complexities and administrative difficulties of a more complete integration system, but has none of the benefits that might be expected from such a system. As Congress searches for additional revenue, the special 10% deduction should be the first candidate for elimination.

4. Itemized Personal Deductions. None of the proposals make major advances in the case of the various itemized personal deductions as such, either in terms of tax simplification or tax equity. Of course, since all four raise the zero bracket amount, fewer taxpayers will be required to itemize and thus some simplification is achieved. The President's, Treasury 1 and FAST tax proposals would eliminate the deductions for state and local taxes. The FAST tax proposal would repeal the deduction for non-mortgage personal interest. The President's and Treasury 1 proposals would allow interest (other than on a principal residence) to be deducted only up to investment income plus $5,000. All proposals retain the major itemized deductions for home mortgage interest, charitable contributions, and medical costs.

Considerable attention has focused on the President's proposals to repeal the deduction for state and local taxes. The principal taxes involved are state and local income taxes, property taxes, and sales taxes. Somewhat different policy considerations should be taken into account as the proposals to eliminate the deduction for the various types of taxes are considered.

The deductions for state and local sales taxes and for property taxes can be viewed as a form of revenue sharing effected through the tax system. This analysis holds, however, only where the taxes represent personal consumption expenditures of the taxpayer and not where they represent costs of a trade or business or of producing investment income. The President's proposals recognize this distinction and allow the deduction for such taxes where they are income-producing costs. Insofar as the taxes are not related to an income-producing activity, they may represent consumption costs in the case of sales taxes and costs associated with personal residences in the case of individuals who are buying, for the most part, services for the payment of the property taxes. If direct revenue sharing is to be repealed, it appears logical to repeal the revenue sharing run through the tax system.

The deduction for state and local income taxes raises some difficult conceptual issues. Under the President's proposal, the deduction would be allowed to corporate taxpayers, presumably because the tax is recognized as a cost of producing income. On the other hand, the deduction would not be allowed for unincorporated enterprises or for individual employees. If state and local income taxes represent a cost of doing business for a corporation, it is difficult to see why the taxes are not likewise a cost of producing income for an unincorporated business enterprise. If this conceptual step is then taken, the question arises whether it is possible to distinguish between individuals whose employment represents their trade or business as compared to self-employed individuals. If one cannot satisfactorily distinguish between income taxes incurred as a cost of producing employment income from those incurred as costs of producing business or investment income, then the conclusion would have to be drawn that a deduction for state and local income taxes should be allowed as a deduction from gross income for all taxpayers.

On the other hand, the question whether state and local income taxes should be deducted by individual taxpayers may in part turn on imperical data. The President's proposals assert that state and local income taxes are simply costs incurred by individuals to obtain services from state and local governments. In part this may be true to the extent that state budgets financed by income taxes are expended for items such as highways, schools and other services. On the other hand, to the extent that state income taxes fund transfer payment programs for welfare programs and the like, the argument is much less persuasive.

Based on the above, Congress might wish to consider a compromise. The deductions for state and local property for non-business property and sales taxes could be repealed as the President has recommended. This action would be taken on the basis that revenue-sharing programs by the Federal Government are to be dismantled and there is no reason to maintain a revenue-sharing program in the tax system. On the other hand, the deduction for state and local income taxes could be converted to a tax credit (or, alternatively, allowed as a deduction only against the 15% bracket of income in a fashion similar to that employed in the FAIR tax proposal). This action would represent a middle ground between complete deductibility and total repeal.

The President's proposals also assume that the deductions for charitable contributions, medical expenses, and home mortgage interest should not make any contribution to the revenues necessary to achieve lower rate reductions. So that all of the burden does not fall on those who rely heavily on a deduction for state and local income taxes, Congress might consider an across-the-board reduction in all four major itemized deductions, e.g., taxpayers could obtain a deduction only for 80% of their charitable contributions, medical expense deductions, home mortgage interest, and state and local taxes. (The appropriate percentage reduction would be set by revenue considerations.) This action would spread the cut back on tax expenditure programs across the entire group of itemizers, rather than concentrating the reduction entirely in one program which has varying benefits among itemizers.

5. Tax Shelters. The President's proposals contain some measures designed to cut back on the benefits of tax shelters. It seems unlikely that his proposals will be effective.

With respect to the real estate tax shelter, as noted above, the combination of the President's proposed depreciation schedule for real estate and indexation of the depreciation base produces a more generous deduction system than at present. Of course, the value of the deductions is reduced because the top bracket is reduced from 50% to 35%. However, this reduction in the marginal tax rates only affects the pricing of the tax shelter and does not get at the fundamental building blocks of a tax shelter: accelerated depreciation and leverage. The President does recommend extension of the at-risk rules to real estate, but it would appear that transactions could still be structured in such a way as to provide sufficient deductions to investors on a current basis so that the tax shelter activity would remain attractive.

What is required is a much more fundamental approach to the problem of depreciation which is generated by debt. The basic principal which Congress should adopt is that depreciation deductions may only be taken on the equity investment that a taxpayer has in the asset. It should be irrelevant whether financing is recourse or nonrecourse. Depreciation deductions should not be allowed to be taken faster than the mortgage loan is being amortized. The at-risk rules do address the problem of abusive tax shelters which employ excessive valuations. They do not however address the more fundamental problem that allows depreciation deductions to be taken faster than equity is invested in the property where the debt is recourse. Although the Treasury proposals have ended the conversion feature involved in the real estate tax shelter, i.e., by disallowing long-term capital gains treatment upon the disposition of depreciable real estate, that factor never has been much of an element in the marketing of tax shelters. The typical tax shelter projections run out for 20 years and the present value of a possible tax liability to be incurred in 20 years is a very small concern to the average tax shelter investor.

SPENDING OBJECTIVES OF GOVERNMENT

All four of the major tax reform proposals assume that revenues derived from repeal or modification of existing tax expenditure provisions should be funneled into reduction of rates for individual and corporate taxpayers. That assumption is not unassailable. There are many in and out of Congress who feel that the objectives of the spending programs run through the tax system are necessary and worthwhile, directed to activities and persons for which federal financial support should be provided. The four comprehensive tax reform proposals thus explicitly or implicitly take the position that all of the special deductions and tax credits which they repeal represent unnecessary and/or undesirable Federal spending. It is, of course, possible to take a different view. That is, when a tax expenditure is repealed Congress can consider the question whether it should be replaced by a direct spending program. Moreover, when Congress decides to continue a particular tax expenditure, it is always possible that it can be continued at a reduced revenue cost by more effectively targeting it and by insuring that it is treated properly for income tax purposes. Of course, the continuation of spending programs, whether run through the tax system or through direct programs, requires that the programs be financed through higher tax rates than would be required if these programs were eliminated.

The present tax administration system is overwhelmed by the presence of so many tax expenditures. And the existence of the tax expenditures requires more complex forms, complex income tax regulations, and increased tax litigation. It can be strongly argued that these concerns can and should overwhelm any demonstration of need for a federal subsidy program run through the tax system. But is important to note that they do not overwhelm a demonstrated need for a federal subsidy program run outside the tax system. Undoubtedly Congress will hear from every group that will have its tax subsidy repealed or modified by any of the four major comprehensive reform programs. It is important to keep in mind as these groups state their cases that the tax system is not the only response the Federal Government can make to their pleas for federal financial assistance. The direct spending route is available. Even if it is politically impossible to use the direct spending route, it will frequently be possible, where Congress is ~~satisfied th~~at a need for federal financial assistance has been demonstrated, to provide that assistance through the tax system in a cheaper and more effective way than is done by most present tax subsidies. Moreover, as I have indicated above, it is possible to structure tax subsidies in such a way that the demands of tax equity can be met, namely by using taxable tax credits or by imposing interest charges where a loan program is involved. I do not think Americans will object to somewhat higher tax rates than proposed by the President if the Congress can demonstrate to them that funds are being expended through the tax system in an effective and equitable fashion which guarantees that all Americans pay their fair share of taxes but at the same time provides federal financial support for those activities and situations that Congress deems meritorious.

CONCLUSION

In terms of traditional notions of comprehensive tax reform to achieve horizontal equity and tax neutrality, on balance, Treasury 1 and the FAIR tax proposals deserve high marks indeed. The President's proposals are less clearly entitled to such an evaluation. In some areas, the Reagan proposals clearly improve the tax base, in many others they make no changes, and in a few situations, actually less desirable than present law.

All proposals use revenues from repeal or reduction of tax expenditures to reduce the progressivity of the present rate structure. Congress should be willing to accept higher top marginal rates and more rate brackets to reflect the American tradition that taxes should be based on ability to pay.

Senator KERRY. We would maybe follow up a little bit on that last thought—we'll jump around here a little bit, but if that's true, if we ought to take a look at each one of them, then in effect aren't you making—aren't you really saying that you're going to continue the system as it is today? There's nothing different from that, and—I mean, either you move toward broad simplification or you are simply looking at the equity of each situation that you have today?

Professor MCDANIEL. Well, I don't think those things are necessarily inconsistent. Maybe life has changed in Washington, but I would seriously doubt that Congress is going to get the luxury of not looking at these provisions individually in the course of the legislative debates.

Senator KERRY. That's my point. I think they will; and because they are, it will increasingly make moving toward that full simplification more difficult. And further, each time you step away from it you're going to make that next step away more acceptable, I believe.

Professor MCDANIEL. Well, as I say, what is the right strategy? It's really a question of tactics. Do you do better by just wiping out as much as you can in one fell swoop without asking yourself the question of whether these programs are desirable or not, whether run directly or through the tax system.

Senator KERRY. Well, I take it—the current approach so far, of both Treasury/administration as well as Bradley-Gephardt, has been that sort of three-tiered, somewhere in the range of 15, 16, 26, 25, 35, 36; and needless to say, you've got to arrive somewhere depending on what you give up. You've got to reduce those certain amounts to be neutral. But my question, is there any magic in that? Why couldn't it be 40? Why not 43?

Professor MCDANIEL. There isn't any magic in it. The matter of setting of rates is quite an independent matter from deciding what your tax base is going to be. I think the right way for Congress to approach the matter is, rather than saying we have a present number or rates we've got to hit, to get the tax base as close to correct as possible, and then decide what rate structure will provide the revenues on that base that you need. But there certainly isn't anything magic in rates of 15, 25, and 35, as the President has proposed, or others. Indeed, I think there can be serious questions raised about whether those rates increase equity. In the proposed rate structures you have taxpayers paying the same marginal rate of tax who are in widely variant circumstances. In the President's proposals, for example, a taxpayer making $35,000 is deemed to have the same ability to pay as a taxpayer making $70,000, or double the income. And that seems to me a proposition that is doubtful. Even more doubtful is the proposition that a taxpayer making $75,000 has the same ability to pay as one making $500,000.

I see really no argument at all for dropping the 50-percent rate, at least for those above $150,000 or $200,000, if you're going to keep the preferential rate for capital gains.

Senator KERRY. Now, I suppose from a pure point of view, moving toward something like Bradley-Gephardt makes sense. If you measure it, however, against some of the realities of how people make investments, etc., I wonder if you might comment on the following proposition.

I gather it's about 70 percent of Americans who file short form today, and only 30 percent or so or somewhere in that vicinity are actually deducting. Therefore, if we're trying to simplify for the broad spectrum of America, and 70 percent are already dealing with a very simple form, already 70 percent are, then we're looking at the 30 percent in trying to decide what's fair or unfair within that scheme. It seems to me that if you look at something like the deduction, is there a possibility that we are reaching too far in trying to set up certain things as part of reform whereas, in fact, they're going to have—in some cases, perhaps, disastrous and certainly in many cases a negative impact on a current economic—a current way of doing business. In other words, perhaps we're going beyond where we ought to be, given that effort to seek equity. I wonder how you'd respond to that. I'd like anybody, perhaps, to respond to that.

Professor McDaniel. Well, you're right in terms of simplification. Both bills do—or all the bills do—gain some simplification because they increase the zero bracket amount, which serves as a floor for the itemized deductions. And therefore you'll have more people using the short form. And so that will achieve some simplification.

With respect to the itemized deductions that remain, they really, again, are the equivalents of spending programs run through the tax system. The itemized deduction for State and local taxes is really a form of revenue-sharing. It has peculiar effects because it does go only to States with high income or other taxes and with a large number of people living in them who itemize. It thus has some odd effects as a revenue-sharing program.

If Congress is going to terminate revenue-sharing directly, I guess it may make sense to terminate it indirectly as well because it doesn't seem to make much sense to terminate a direct revenue-sharing program and keep one that's run through the tax system. And that will obviously have some effects on those States and people in those States who are getting the benefit of this particular Federal program at the present time.

I think the problem might be that there is so much pressure—viewing it as a tax reform matter—being put on one deduction. It might be that Congress would do better to adopt an across-the-board reduction in all those itemized deductions, say, allowing taxpayers to deduct 80 percent of each of them rather than just putting all the revenue pressure on one item, as is done in the President's proposal.

Senator Kerry. Well, I wonder if you would comment, also, and again—do you want to comment on that, Mr. Neises?

Mr. Neises. I don't have too much to say other than that simplification, I think, is important. We ought to do it. I've heard the theory that if everyone's ox is gored a little bit, it would be a lot more palatable than continuing what I think are, let's say, some extremely favorable treatments vis-a-vis oil depletion and whatever that might be. I think we're all willing to tighten our belt a little bit, and if this idea of 80 percent of everything—that might be a fair way. The minute you let the cat out of the bag and let some special interest group do it, I guess that defeats your purpose.

Senator **Kerry**. Do you have a preferred approach with respect to depreciation?

Mr. **Neises**. Well, right now, for real estate I guess it's 15 years or so; that, to me, seems reasonable. Accelerated depreciation, I think, is a good thing in the high-technology world that we live in. Things wear out, especially computers, very rapidly. It would seem to me that people ought to get that choice, if it can be done.

Senator **Kerry**. Between the Treasury I and current, are you familiar with those, the way they treat it differently?

Mr. **Neises**. I don't know the details.

Senator **Kerry**. Do you have a preference?

Ms. **Walkerman**. I just want to comment on the simplification question.

In dealing with small business we have to recognize that anytime a person has a complicated situation, which is usually the case with small business, where you, say, have a sole proprietor who has an individual side of his tax situation and a commercial/business side, or even a small, closely held situation, those people that have complicated factual lives, that's going to get translated into complicated tax situations. And I think it's just plain unrealistic to think that we could have people in small business in a position to be able to file short forms or greatly simplified tax returns generally. They'll have the schedule C's and the deductions and the business-related deductions and all the little pieces that just plain go into calculating what their income is, even if you get rid of special credits and so forth.

Senator **Kerry**. Now, I think every proposal thus far sought has proposed getting rid of the investment tax credit. How do you respond to that? Is there any—I've heard some squeals, but I haven't heard them yet here.

Ms. **Walkerman**. I guess my bottom line is that if getting rid of the ITC goes along with getting rid of other kinds of preferential items and preferential treatments, I would not be opposed to that. I think——

Senator **Kerry**. Which others most come to mind in the tradeoff?

Ms. **Walkerman**. Depletion. There are some special, not too well-known credits for boxcars and some of the more esoteric tax shelter deals.

Senator **Kerry**. In line with that—I want to come back as part of my original question, which I may not have phrased that clearly, but I'm still trying to get at it—as I hear people articulate their problems with the current proposals or with the current system, it keeps coming back to a fairly clearly identifiable group of so-called shelters or, in some cases, give aways, special interests, carved-out entities. Why should tax reform not amount solely to getting rid of that specifically identifiable group of most egregious loopholes, so to speak, whether it's rolling stock—we got rid of movies; real estate, to a large degree, is maybe—I mean, why isn't it that core group?

Ms. **Walkerman**. Well, I think it could be done that way. Unfortunately—what I've seen is that in trying to close one loophole, you usually open another and also make greater complication. Without having a whole lot of technical background on that—for example, the whole minimum tax and tax preference calculations are attempts to get at the most egregious tax shelters. And that adds elements of complication, even in my simple tax world.

So I think that if Congress can find ways to get at those without overcomplicating other things, that would certianly be a good approach.

Senator KERRY. Paul, do you want to comment?

Professor MCDANIEL. Well, that really takes the approach, as I mentioned earlier, of looking at these items one by one and making a decision about each as to whether it's in the national interest to provide a subsidy to this particular activity; and if so, is it structured well to produce the maximum benefit for the cost.

Senator KERRY. Let me add a question to that. Do you believe that, given the approach of some other Governments, and particularly the ability of some businesses to get capital at cheaper cost than we provde it here in America, do you believe it is possible for us to complete without using the tax structure and without having some of those kinds of benefits available in order to redress inequities between ourselves and other countries?

Professor MCDANIEL. Well, that's a very complicated question. It's certainly true that every country uses its tax system to provide incentives or assistance for particular kinds of activities or investments. The competitive element, really, in a sense, depends upon the form in which the U.S. company goes into the other country if that's where the competition is going to take place because then you're operating under their tax laws; and then conversely, as I mentioned earlier, they're coming into our country and competing with our businesses, and then they're worried about what our tax laws are.

In trying to isolate those factors out as to whether we come out net winners or losers from tax subsidies, it would take a more sophisticated economic analysis than I can give you to answer that question.

It is interesting that Great Britain has decided to follow the route in connection with depreciation, for example, of the Treasury and the President's proposals. They had a system of immediate writeoffs of all capital costs, which they have now repealed, and are going gradually to a system closer to economic depreciation, coupled with a drop in their corporate tax rate; so that they, apparently, at least, decided that lower rates where preferable to subsidies through depreciation. I'm sorry I can't respond to the broad question.

Senator KERRY. Well, maybe it's too broad, then.

With respect to the fear that you underscored—we're going to have to close this panel off in a moment because of the time—but with respect to the fear that you underscored about foreign corporate moves to this country should our rate drop to the 33 percent, which would attract them, is it your sense—or maybe you have some information on this—that that would provide a greater tradeoff in numbers of jobs created in this country, even though they're competing with our products with their final product, or not?

Professor **McDaniel**. I don't know. As I say, it seemed to me that there was a probable effect there that needed to be looked at it. It might well be a net benefit to it or it might not, but I only can raise the question. Unfortunately, I can't answer it.

Senator **Kerry**. OK.

Jack, one last question before we finalize. I'd like to ask you, with respect to the entrepreneurial outside investor perspective, what would you say is the most critical element that we should keep our eye on in providing for that ability to deal with the risk?

Mr. **Neises**. I think the most important—the centerpiece of all of it—should be that capital gains taxes are lower than ordinary income. And I think most western nations other than the United States encourage long-term investing even more than we; they tend to have very high ordinary income taxes, to want to go into job creation by building, machinery, factories, or to create the workplace for these workers. They generally tend to reward capital gains even more highly than we do. So I would say, by all means, don't tamper with that.

Incentive stock options are important, but the capital gains differential is the most important, having observed what it was like when it was the same as ordinary income.

Senator **Kerry**. And the spread in Treasury, too, is satisfactory? That's about 17.5?

Mr. **Neises**. That's fine. That's at two to one; that's a good relationship. It's about that now, and it really works. And it really did not work when it was the same.

Do you agree with that, Betsy?

Ms. **Walkerman**. Yes. I would just add emphasis to that.

Senator **Kerry**. Is there anything that you would want to do or see us try to do with respect to available capital, particularly for small businesses?

Mr. **Neises**. I think if you give incentives and rewards for people to take risks, which you will be doing, that capital will come. I've seen it; it will come from university endowments, from a lot of places, because even though they're not taxed, they get caught up in the whole swing, the job creation that's happening. But many people do pay tax—wealthy people, corporations, people that really control a lot of this money—and it will come if you reward it.

Senator **Kerry**. And one final last question, minimum corporate tax.

Mr. **Neises**. I think that the level that we're at now certainly stimulates business to take risk. I don't feel strongly that it has to be reduced to 35 percent or whatever.

Senator **Kerry**. Thank you. I'd like to thank you, and I think it opens more questions than it answers, but it's a beginning. I thank you very much for adding to the dialog, and it is rekindling curiosity or keeping it alive. Thank you.

If the next panel would shift off with them, I would appreciate it very much.

I have to try to improve on the Senator's example here, so if I could ask you—Mr. Thornton Stearns is from—is it Vacum?

Mr. **Stearns**. Vacuum Senator. Thank you. I think maybe Mr. Haddad should go first.

Senator **Kerry**. All right; fine. And Mr. Robert Haddad from Price Waterhouse & Co., and Mr. John Buckley from Ernst & Whinney from Boston. And they are representing the accounting side of this question, and we'll turn to Mr. Haddad first.

STATEMENT OF ROBERT L. HADDAD, PRICE WATERHOUSE & CO., BOSTON, MA

Mr. **Haddad**. Thank you, Senator.

As Paul McDaniel says, it's an impact on you that we're not going to be able to share in terms of buying that extra time. It's good to know.

Just to correct one thing, and I recognize that there was some confusion in our schedule. I am here, as is Thorny, representing the Smaller Business Association of New England in our position on the respective tax proposals that we have been reviewing over the past number of months, about a dozen, I guess, and I would just like to say that I have submitted complete, indepth testimony for the record and will proceed to summarize our position at SBANE and highlight some of the more significant issues that we are concerned with.

Let me identify just a couple of things that I do, as well as being a partner at Price Waterhouse. I am the chairman of the tax committee for the Smaller Business Association of New England, and also a director and a member of the executive committee.

Let me start with my summary statement, and I would like to read that.

The Smaller Business Association of New England does not feel that there is anything inherently wrong with the simplification and reform of our current tax system. In fact, we strongly endorse simplification and the uniform application of equitable tax law over a sustained period of time, and I emphasize simplification, uniform application, equity, and sustained, because those are the areas that we continue to have major problems in small business. However, SBANE cannot support tax reform proposals that inequitably shift the burdens of taxation on small business—for example, as Treasury I did where their proposal on the rate change as it affected small business caused a projected $30 billion increase in the corporate income tax that would have been assessed against small incorporated businesses over the 5-year period running through 1990.

SBANE believes that prior to the implementation of any such tax reform alternative a careful and indepth analysis of the alternative's impact on small business must be undertaken. You will listen to it today, you'll read about it in the literature, in the newspapers, and will continue to see that nobody really understands the impact of the proposals, never mind on small business but on the economy as a whole, on the flow of revenue, on the impact on international trade and competition or, for that matter, probably in a number of the other areas. Everybody has an idea but they really don't know, and it certainly hasn't been quantified. Some of the points that Paul McDaniel made, and other members of the first panel, give clear evidence of that, and some of the questions that you asked, Senator.

The fact of the matter is that not only was small business not properly examined in terms of the impact of the proposals, but the revenue flows, the expenditure flows and all the other flows and impacts are not adequately measured before the proposals are coming out to the press. So we are concerned as small business, since we do not have comparable political clout, that the proper analysis be made before the proposals and/or the legislation come to bear and we have to go and testify in Washington, which is projected to be in the fall.

The analysis must include an evaluation of the increase in the tax burden relative to big business along with a study of the inordinate payroll tax burden which is synonymous with small business ventures, and that I'll talk more to later. Also, it is imperative, due to the inequitable access to capital that plagues small business, that any such tax reform proposal be thoroughly scrutinized as to its impact on small businesses' ability to generate capital, either internally or in the marketplace.

With respect to the current proposals, our tax committee for the past 12 months has been reviewing a variety of proposals, culminating in limited review—to date, anyway—of the administration's most recent proposal. I would like to comment on a couple of the areas. We are hearing quite a bit about some of them, so I'll be extremely brief on those issues, such as capital gains and spend a little more time on areas that I think will not get adequate coverage this morning.

The lower marginal rates which were proposed and which were discussed earlier favor, certainly, unincorporated small businesses. I think the numbers bear that out. It's obvious that it's a rate reduction and it's clear that it should enable small, unincorporated businesses to generate additional capital, which should enable them and help them to grow and hire additional people.

With respect to incorporated businesses, I would point out that with the exception of the most recent adminstration proposal, most all of the proposals that we studied demonstrated a willingness to eliminate the graduated rates at the corporate level. We perceive this to be—and testify on the matter—as a major disaster for small business and, fortunately, some of the work that we've done in the past few months has gotten that to be changed. We strongly endorse and virtually—in fact, insist—that we have a graduated rate structure for small business. The tax burden for small business right now, incorporated businesses, probably as well as unincorporated, is a greater—when you look at rates—it's a greater rate, effective rate, than it is in large companies. And that does not include the payroll tax and other tax burdens which we can talk about in a few minutes.

So that matter has to be dealt with—the tax burden on small businesses, be it the rate area or the payroll tax, has to be dealt with, and the preservation of the graduated rates is essential in order for that parity to at least hold to where it is today. It's still not equitable.

In the area of industrial revenue bonds—I would only like to say that we encourage and have encouraged for years the preservation of industrial revenue or industrial development bonds as a necessity from small business because of the need for them to generate capital, which is not an easy prospect and project for samll business. Bank financing is more expensive; public market access is not there; internally generated capital is difficult. And, as was explained earlier, it is very difficult to generate capital internally, especially in the early stages of a business.

So we're concerned that some manner of an industrial revenue bond or equivalent be maintained or preserved, and we would endorse strict limitations to be imposed on them in order that they do not—the abuses do not persist that we have seen in the past. Private purpose bonds clearly have a place in Massachusetts, as I think you well know, Senator, and a recent study that Coopers & Lybrand did which I included some material on in my testimony demonstrates the impact that IDB's have had on the Massachusetts economy.

With respect to capital gains rates, I think it's all been said. SBANE clearly supports a differential in the rates as an absolute necessity in order to provide for the risk capital that is otherwise very difficult to achieve in a small business environment.

The recent proposal, and some of the earlier proposals, have suggested the preservation of the R&D credit. And where you had asked about the investment credit earlier, Senator, we endorsed that particularly from a New England perspective, given the high-tech nature of the New England economy. Not that that's all that we have, but certainly, the R&D has had a major impact. And in terms of the President's objective and, I think, a lot of other congressional people have spoken to the issue of the need to keep economic vitality—not only in New England, but of the country—going. We are losing, I think, a significant opportunity vis-a-vis the Japanese in the R&D area. I read recently where several of the major—national semiconductor companies, TI National Semiconductor, and so forth, have pulled out of the development of the 256K RAM's and ROM's, and they basically capitulated to the Japanese because of the position that they have relative to the United States. That is the worst thing, I think, that any of us would want to see, is to see some of our logic companies pulling out of the R&D area because I think that what was mentioned earlier, the feeder companies, the small companies that feed and work with the larger companies, it could be a disaster in the long run for New England.

So we are strongly in support of the need to preserve the R&D credit if there is going to be a credit. If there's not going to be a credit, that's another whole story and we don't have the time for that, but investment tax credit shouldn't really be the hot button for small businesses since they're labor-intensive and not capital-intensive. The jobs credit is much more appropriate if one were to talk about having that kind of policy in the law, but that's the topic of another whole discussion, whether it be R&D, jobs, or ITC.

With respect to the taxation of fringe benefits, most all of the proposals included some element of a fringe benefit which is currently nontaxable as taxable under their proposals. Probably the one that was least egregious, if that's the right word, in terms of how much they wanted to tax was the most recent proposal which talked about maybe $300 a year of someone's health benefits being subjected to tax.

For reasons that I'll mention in a minute, on the payroll tax. SBANE cannot really endorse this across the board for small business. I understand, and we have studies, the fact that there aren't many places that the Government is going to get revenue. This is the problem, that this area enables the Government to look at, in 1990—if you look at all of the fringe benefits where companies are avoiding taxation on fringe benefits, you're talking about $100 billion. It's the single largest revenue-raising factor that the Joint Committee and the OMB look at. So they want that source to begin, and it concerns us, but I can understand why they're going after it. There aren't a lot of places they can go after to get more tax dollars. Depreciation is only a $45 billion ticket item—only—I'm starting to sound like I spent time in Washington. [Laughter.]

It's a $45 billion item, and the home mortgage interest disallowance is about a $40 billion item. So the fringe benefit area is a crucial one of them, but from a small business perspective, since we're labor-intensive, this could be a disaster. If it's going to happen, we would propose that there be some sort of a cutoff provision where companies under a certain size are not subjected to the taxation under the fringe benefit rule—say, a $10 million asset size or revenue base or something. If it has to happen, then at least give the small businesses a chance to get large enough to absorb the cost of doing it.

With respect to the payroll taxes, it's the last area I'll comment on before my conclusion. I think that this issue is the most understated, and as far as I'm concerned, the most significant burden for small business. My involvement with the Small Business Administration Tax Task Force in the White House Conference—recently I raised the issue and asked them to confirm that the payroll tax burden is the most significant tax burden for small business. They have come back and stated that, in fact, it's about twice the income tax rate burden for small business. And so what we've seen in the past few years has been a spiralling, skyrocketing payroll tax increase for everyone that's on a payroll—all companies pay it—and it's most abusive when you relate it to small business because small business is labor intensive.

First of all, the tax is regressive because it kind of disappears as the salaries go up. Larger companies pay larger salaries, generally, so that the 7 percent FICA tax that the employer pays becomes a smaller effective percentage when the salary runs up to $100,000. And so a small company that generally pays more small salaries and fewer larger ones pays a higher effective payroll tax relative to the sales dollar, cost of operations, net worth, or net asset base.

So I think, really, that this is the sleeper. In a recent study that Price Waterhouse did perform nationally, and then we regionalized it, 96 percent of the respondents said that, as a matter of public policy, the payroll tax was their No. 1 concern; 96 percent, which is absolutely astounding when you think about it. Nationally, I think, it was about 83 percent; I don't have that statistic with me.

But it's of concern in New England because of the nature of the business we have here. It's absolutely astounding.

I would just concluded that a lot of what we have worked on in the past 12 months and will continue to work on deals with the equity in the tax law. We at SBANE feel that the Reagan proposal, which still needs a lot of work in the area of impact analysis—as do all of the other proposals—at least embodies some of the concerns that we have had, such as the graduated rates, diminimous provisions in there for tax recapture and other rules that they have put in. At least, there's a good starting point for small business and we do endorse that concept subject to, again, a lot of what is starting to come out, the analyses and the revenue impact studies.

OK, sir.

[The prepared statement of Messrs. Haddad and Stearns follows:]

TESTIMONY OF
THORNTON STEARNS
TAX POLICY SUBCOMMITTEE CHAIRMAN
AND
ROBERT L. HADDAD, C.P.A.
TAX COMMITTEE CHAIRMAN
SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE)
WALTHAM, MASSACHUSETTS

BEFORE
SENATOR JOHN F. KERRY
SENATE SMALL BUSINESS COMMITTEE
CONCERNING
TAX SIMPLIFICATION AND REFORM
JULY 3, 1985

TESTIMONY
PART I

I. Introduction

My name is Bob Haddad. I am a Small Business Tax Partner at Price Waterhouse in Boston. I am also Chairman of the Tax Committee and a Director of the Smaller Business Association of New England. (SBANE)

This is Thornton Stearns. Mr. Stearns is President of Vacuum Barrier Corporation located in Woburn, Massachusetts. Vacuum Barrier Corporation is a small manufacturing firm employing forty individuals. He is also Chairman of the SBANE Tax Policy Subcommittee. Mr. Stearns will share with you his insiders view of the impact of tax reform on small business.

Our committee has been very active in recent years with regard to various tax issues affecting small business. The Tax Committee has played a strong role in the establishment of SBANE as an influential voice of small business.

The Committee's activities are varied. Among other endeavors, the Committee organizes meetings with Congressional representatives, analyzes and evaluates proposed legislation and members often testify with regard to the impact of the proposed legislation upon small business. Today we have been called before the Senate Small Business Committee to testify concerning the impact of the major tax reform and simplification proposals on the small businesses of New England.

II. Summary Statement

The Smaller Business Association of New England does not feel that there is anything inherently wrong with the simplification and reform of our current tax system. In fact, SBANE strongly endorses simplification and the uniform application of equitable tax law over a sustained period of time. However, SBANE cannot support any tax reform proposal that inequitably shifts the burdens of taxation on small business.

SBANE believes that prior to the implementation of any tax reform alternative a careful and in depth analysis of such alternative's impact on small business must be undertaken. This comprehensive analysis must include an evaluation of the increase in tax burden relative to big business along with a study of the inordinate payroll tax burdens synonomous with small business ventures. Also, it is imperative, due to the inequitable access to capital that plagues small business, that any such tax reform proposal be thoroughly scrutinized as to its impact on small businesses' ability to generate investment capital.

III. Review of Current Reform Proposals

In recent months our tax committee has reviewed and extensively analyzed the major alternative tax system proposals to be discussed today: namely, the Bradley-Gephardt Fair Tax proposal, the Kemp-Kasten Fast Tax proposal, the initial Treasury

Tax Reform proposal and the recently released Administration proposal. Our findings are summarized as follows:

A. Lower Marginal Rates

Unincorporated Small Businesses - The proposed decrease in marginal rates is very attractive to owners of unincorporated businesses such as sole proprietorships or partnerships. The Treasury has estimated that 78% of all individual taxpayers would experience a reduction in tax. Thus, the reduced rates, should enable unincorporated small businesses to retain more internally generated capital.

Incorporated Small Businesses - Institution of a flat corporate rate somewhere in the low thirty percent range would have a disproportionate impact upon incorporated small businesses having less than $100,000 in taxable income in a given year. Due to the proposed repeal of the graduated corporate income tax for earnings of less than $100,000, marginal rates for these corporations would be sharply increased. Even a corporation with taxable income of $100,000 will face a 28% increase in its effective tax. These smaller corporations represent 90% of all U.S. corporations, or about two million incorporated entities. A recent study initiated by a national public accounting firm concludes that for the five year period 1986-1990, the lowering of the marginal rates provided by the initial Treasury proposal which eliminated the graduated rates would increase the tax for those corporations with taxable income of $100,000 or less by $31 billion while higher earning corporations would enjoy a $204 billion reduction.

SBANE believes that all reform proposals involving rate change must maintain some form of graduated scale so as not to disproportionately increase the tax burden of smaller businesses. SBANE strongly supports the inclusion of such graduated rates in the recently released President's tax reform package.

B. Industrial Development Bonds

Elimination of "private purpose bonds", also known as industrial revenue bonds or industrial development bonds is incorporated into almost all alternative tax proposals. The debate on industrial development bonds (IDB's) has endured many years. The proposals to eliminate private purpose IDB's are a classic example of the lack of our government's clearly defined national policy. A study recently prepared by a national CPA firm for the Massachusetts Industrial Finance Agency concluded that almost 70% of the companies receiving IDB financing had fewer than 200 employees and sales of less than $20 million. Almost 50% of this financing went to firms with sales of between $1 and $5 million. Note that the famous "Birch" study at MIT identified this size company, both incorporated and unincorporated, as generating over 50% of the new jobs created nationwide. The firms responding to the Massachusetts survey had an average growth in jobs of 24% after receiving the favorable financing; whereas the Massachusetts statewide manufacturer employment rate decreased by nearly 1%. My own experience has been that the vast majority of small businesses could not have added manufacturing, warehousing and distribution facilities if it were not for the availability of long-term money at reasonable interest rates through IDB's. These funds are the cornerstone of small business growth. Where can smaller business turn if this source is eliminated?

SBANE supports retention of industrial development bond financing as a much needed source of capital for small business growth. SBANE does, however, recognize the margin for abuse involving current IDB financing. As a result, SBANE proposes a gross receipts cap limiting the benefit of IDB's to smaller businesses. Also, a cap could be instituted limiting the amount of IDB's available to a particular business within a certain time span.

C. Capital Gains Rates

The Bradley-Gephardt proposal would tax long term capital gains as ordinary income as did the initial Treasury proposal. The Kemp-Kasten proposal significantly reduces the rate benefits applicable to capital gains. The Administration's proposal maintains and, in fact, increases the rate benefit applicable to long term capital gains.

Any reduction in preferential rates for capital gains will have a significant detrimental effect on investment in small businesses. Capital formation is a very serious problem for small businesses. Small businesses have a very restricted access to cash through normal channels - at reasonable rates. Preferential rates for capital gains represent a reward for placing capital at high risk and are, thus, a critical element in the capital formation of these small businesses.

In order to promote investment in small businesses and assist in providing access to capital, SBANE supports the maintenance of a clear differential between the tax rates applied to capital gains and those applied to ordinary income.

D. Research & Experimentation Credits

Excluding the President's tax reform plan, tax reform proposals have generally mandated the elimination of the tax credit for increased research and experimentation expenditures.

The credit for increased research and experimentation expenditures is intended to act as an incentive for technological innovation. The credit is intended to serve as a reward for those who place their capital at risk in developing new and innovative technology. Small business is the major source of technological innovation in our economy. The credit allows small businesses to retain more of its internally generated capital. As such, it is an instrumental element of the capital formation of small business. The importance of the credit to small businesses in New England was recently documented in a joint study undertaken by SBANE and the national public accounting firm of Ernst & Whinney. (The study is attached as Exhibit I).

SBANE strongly supports the retention of the research and experimentation credit in the President's tax reform proposal. SBANE believes that this credit plays a major role in the economic vitality of our country.

E. Fringe Benefits

Elimination of the current exclusion from gross income of at least some employer provided fringe benefits is proposed by all of the alternative tax proposals. For example, the President's proposal would limit the exclusion available on employer provided health insurance. Those benefits which would be subjected to taxation under at least one of the alternative tax plans include group term life insurance, the special treatment of cafeteria plans, educational assistance programs, legal services and dependent care.

Although the above changes will adversely affect all businesses, the impact will be more burdensome on small business because of its inherent competitive disadvantage. Small businesses do not stand on an equal footing with large businesses in their ability to provide fringe benefits. Lack of sufficient profitability is the major obstacle preventing small businesses from offering more generous employee benefits. However, the ability of small business to offer employees a somewhat competitive package of compensation remains an important factor in their ability to compete with larger firms.

Most owners of closely held companies feel an obligation to their employees which is markedly different than that which exists in big businesses. I have been told by several owners that if such fringes were taxed, the owners would pay their employees increased compensation so as to leave them "whole" on an after tax basis. This, of course, would increase significantly the cost of operating these small businesses.

As part of an overall reform proposal, SBANE supports the introduction of a threshold size, such as gross receipts of 10 million or less, wherein present fringe benefit exclusions would be retained. However, it should be noted that we are extremely concerned that any taxation of fringe benefits might open the door to further taxation of such benefits in the future. The reason for this concern relates to recent payroll tax history as discussed below.

F. Payroll Taxes

Small businesses are very concerned about skyrocketing payroll costs. Small firms are, generally, labor intensive and a larger portion of their payroll is subject to these taxes. Payroll taxes are normally levied at a flat rate up to a maximum amount of annual taxable earnings. Therefore, these taxes are regressive throughout the income scale. In addition, this increasing tax burden inhibits the growth of labor intensive businesses because the cost of operations rises at a faster rate than in capital intensive businesses.

In an informal survey released by Price Waterhouse, attached as Exhibit II, smaller businesses were asked to rank public policy issues. Ninety six percent of the respondents in New England said that payroll taxes were their number one concern. According to a report from the Small Business National Issues Conference, nine Social Security rate increases totalling 60%, nine Social Security base increases totalling an estimated 677%, three federal unemployment (FUTA) rate increases totalling 94% and three FUTA base increases totalling 133% have occurred or are scheduled between 1970 and 1990.

The SBA has substantiated the fact that the payroll tax burden for small businesses is almost twice as large as the income tax burden. Accordingly, the small business community believes that payroll taxes must become a part of the broad tax policy debate. Despite the immediate as well as long-term problems of funding Medicare, Social Security, and unemployment, Congress must be convinced that the small business community can no longer support a continuing spiral of payroll taxes.

IV. Other Reform Proposals

A. Minimum Tax - The continuing decline in the share of taxes paid by corporations, the large deficits and the substantial notoriety concerning high profit businesses that pay little or no taxes are factors which have caused a number of members of Congress to support proposals to institute new or tighter minimum taxes. All of the proposals employ an alternative minimum tax approach which is similar to the existing alternative minimum tax with respect to individuals. That is, each adds to taxable income an amount equal to the tax preferences as defined by the proposal and reduces such amount by an exemption allowance. This amount is multiplied by a flat rate and the resulting figure represents the minimum amount of tax payable by the corporation.

SBANE recognizes the need for corporations to remit their fair share of taxes to the government. However, depending upon the exemption amount and the rate applied, this minimum tax could be used as a vehicle to increase the taxes paid by those corporations with taxable income of less than $100,000. That is, those corporations currently benefiting from the graduated rates below $100,000 in taxable income. Therefore, SBANE supports the institution of an exemption amount and a rate which will guarantee the preservation of the surtax benefit.

B. Value Added Tax - Discussions concerning the institution of a value added tax system have been ongoing for a number of years. The VAT is an indirect tax that is imposed on each sale beginning with production and culminating with sale to the ultimate consumer. The tax is applied at a flat rate much like a sales tax, however, the rate is generally much higher. The ultimate goal of the system, after offsetting VAT previously paid by sellers, is to impose a tax at each stage of production on the sum of wages, interest, rents, profits, and other factors of production not furnished by suppliers and previously subjected to the tax at an earlier stage of production. That is, a value added tax.

The recent survey of the members of the Smaller Business Association of New England and other regional executives, undertaken jointly by Ernst & Whinney and SBANE, indicated that, among companies with ten or fewer employees, 79% of the respondents oppose institution of a VAT system (See Exhibit I). In fact, 71% of the total respondents, whether representing big business or small business, oppose a value added tax.

SBANE opposes institution of such a VAT system. This system would be inordinately difficult to administer no matter what the size of the venture. Such an administrative burden would, however, obviously have a disproportionately negative impact on small businesses with fewer employees, less specialized expertise and less capital.

V. Assessment of Economic Impact of Proposals

As previously mentioned, the small business community cannot overemphasize the need for an intensive economic analysis to be performed measuring the impact of various reform proposals on all segments of our economy. The elimination of numerous tax credits and deductions which businesses have relied upon and planned within for many years is no small task. SBANE must be assured that intensive research will be performed analyzing the impact of proposed tax reform legislation on the economic vitality of all segments of our society. The research underlying the current proposals appears to be somewhat less than comprehensive. For example, the initial Treasury proposal did not fully assess the impact of the plan upon small business. This was evidenced by the elmination of both the graduated rates and the preferential capital gains rate. The President's proposal to limit the deductibility of business meals and eliminate the deductibility of entertainment expenses has a potentially devasting impact on numerous small businesses. This also appears to have been overlooked in the drafting of the President's proposal which only speaks to the purported abuses and not the potential impact on small businesses..

VI. Alternative Tax Proposals - Impact on New England

New England possesses a unique economic climate. It is an area of relatively low unemployment, documented business growth and continuing start-ups. Small business has and will be a major force in this economic vitality. The joint study on small business previously mentioned, indicated that a slight majority of the small businessmen responding oppose a new business tax system that would reduce the top corporate rate and eliminate many business deductions and credits.

It appears that this less than enthusiastic response to tax reform is based primarily on a concern with regard to any new system's incentives for capital formation. Small businessmen continuously rate as their top concern, regarding an alternative tax system, its ability to stimulate capital formation. Items stimulating such capital formation include the research and development credit, preferential rates for capital gains, jobs credits, the investment tax credit, industrial development bonds and SBA guaranteed loans. One might postulate that an alternative tax system that adequately addresses the capital formation concerns of small business would be supported.

VII. Conclusion

The Smaller Business Association of New England and the small business community feel that tax simplification and reform in effort to make our system more efficient and equitable would be beneficial to our economy and society. However, in formulating such alternative system, the incentives and stimuli that have made small business the cornerstone of economic vitality in New England and in the United States cannot merely be ignored. Prior to the enactment of any tax reform package, ardent and intensive research and studies must be conducted to determine the impact on the future of small business. To date, such analyses have only touched the surface with respect to the impact of various proposals on small business.

Finally, we would like to state that the President's recent proposal includes consideration of a number of the concerns that we have raised. Accordingly, we feel that it is appropriate to support the concepts embodied in that proposal, however, we do believe that a great deal of "impact analysis" needs to be performed.

TESTIMONY
PART II

I. Introduction

My name is Thornton Stearns. I am the President of Vacuum Barrier Corporation of Woburn, Massachusetts which is a manufacturer of vacuum insulated cryogenic piping systems. I am also a Director of the Smaller Business Association of New England, a member of the Tax Committee, and Chairman of the Tax Policy Subcommittee.

Mr. Haddad's testimony presents the official position of SBANE. My testimony will be presented as the Chief Executive Officer of a small manufacturing business.

II. Summary Statement

The strength of the small business community is critical to the economic development of our nation. Yet, small businessmen face a constant challenge with respect to the availability of capital. Small businesses simply do not have sufficient access to capital. As a small businessman, I feel that any credible tax reform proposal must simultaneously address this critical situation.

III. Overview

According to data in Statistical Abstracts, Federal, State and Local government spending represented approximately 37.5% of the gross national product in 1981. This percentage has more than likely increased since the time of the study. This represents an intolerable burden on our society. The reduction of federal expenditures and the passage of the proposed tax simplification and rate reduction of both personal and business taxes go hand-in-hand in the necessary and desirable effort to free the creative and productive sectors of our economy.

Tax reform and the reduction of Federal expenditures require corrections of a social and economic nature which will have profound effects on large segments of our economy. The Administration and Congress are now reviewing the various options and actions which will allow the corrective actions to be taken in areas and at rates which can be absorbed by our economy.

I would direct your attention to and urge your consideration of the correction of the bias against private capital.

IV. Small Business and Private Capital

Studies have shown that small business is responsible for nearly all of the job growth of our economy as well as a large part of the development of new ideas and products. The need for private capital exists primarily in manufacturing small businesses. Between $50,000 and $100,000 of capital is required per employee. The startling catalytic effect of this investment of capital can be revealed by putting it in the tax perspective. With good management and a little bit of luck the $100,000 investment can employ a person for a lifetime. Including corporate and individual tax payments, the government can receive hundreds of thousands of dollars in taxes as a result of this investment.

A survey of SBANE members indicated the source of founding capital to be as follows:

Family business	20%
Owners savings	60%
Outside private individuals	13%
Investment corporations	0%
Other	7%

Over 90% used private capital to establish their new business.

Bank credit can be obtained as part of the initital start-up capital, but only if sufficient equity capital exists. Even the useful SBA guaranteed loans, which allow less equity capital, must be guaranteed by personal endorsements.

After the business is established, other sources of capital are used as follows:

Internally generated	70%
Bank loans	50%
Investment corporations	20%
Outside individuals	27%

Outside private capital is still required. Twenty seven percent of the companies use it as a source of growth financing.

Therefore it can be seen that private capital is a critical ingredient to the formation and growth of small manufacturing companies. Yet there are a number of taxes which are specifically directed against private capital.

V. Effect of Taxes on Private Capital

I will now review the major taxes and their effect on the formation of private capital.

A. General

All of the new tax proposals - the President's, the Bradley-Gephart proposal, and the Kemp-Kasten proposal - reduce the top marginal tax rates on both individual and business taxes. This will be beneficial in that it will increase the availability of private individual capital and business capital which is internally generated.

B. Double Taxation of Dividends

The trend in the Administration's two proposals is unfortunate, since the initial Treasury proposal exempted 50% of dividends from corporate taxation, while the President's proposal exempts only 10%. This double taxation has the disadvantage of discouraging equity capital while encouraging borrowed capital. We in business are aware of the disastrous effects of the cost of servicing fixed debt. The Federal

Government is becoming painfully aware of the same effect, now that the payment of interest on debt is a major portion of the deficit. A striking 80% of small businesses surveyed favored the elimination of the double taxation of dividends.

C. Capital Gains Tax

This tax impacts very heavily the initial and growth equity financing of small businesses since the money obtained by selling previous investments is reduced by the capital gains tax. This is very critical since the entrepreneur is trying to scrape up every penny possible to launch his new venture. Seventy percent of the small businessmen surveyed approved modification of the capital gains tax. Half of those surveyed favored a reduction of rates, while the other half favored elimination.

D. Estate and Gift Tax

The Estate and Gift Tax is not a huge revenue raiser for the government. It amounts to only one or two percent of the annual revenues. However, the catalytic effect of the reduction of capital is the converse of the positive effect referred to above. The removal of 50 to 100 thousand dollars of equity eliminates a job and the long term employment of one person along with the loss of hundreds of thousands of dollars of tax revenue.

Furthermore, in a large number of cases, the death of a major owner may force an independent small business to be sold to a larger corporation in order to raise the cash required to pay estate taxes within the year's limit. About 75% of small businessmen surveyed favored modification of the estate and gift taxes as follows:

Increase exemption	32%
Decrease rates	24%
Eliminate	20%
Increase rates	1%
Decrease exemption	7%

Unfortunately, reduction of estate and gift taxes is not part of any of the present tax reform proposals. It would appear appropriate to reduce the maximum transfer tax to a rate equal to the maximum individual tax rate.

VI. Conclusion

There is a critical need for private capital for the formation and growth of small businesses. The growth of employment in our country is dependent on small businesses. I hope that Congress, in the difficult task of developing the priorities and actions for tax reform, will consider the catalytic effect of private capital, and will reduce or eliminate those taxes which specifically tax capital.

Senator **Kerry**. Thank you.

Do you want to add to that, or do we take you separately?

Mr. **Stearns**. I guess I'm second up.

Senator **Kerry**. OK.

STATEMENT OF THORNTON STEARNS, PRESIDENT, VACUUM BARRIER CORP., WOBURN, MA

Mr. **Stearns**. My name is Thornton Stearns; I am president of Vacuum Barrier Corp. of Woburn, MA, which is a manufacturer of vacuum-insulated cryogenic piping systems. I am also a member of the board of directors of SBANE, and a member of the Tax Committee and chairman of the Tax Policy Committee.

Even though I'm listed in the accounting section, I'm presenting my testimony as a chief executive officer of a small manufacturing business.

The strength of the small business community is critical to the economic development of our Nation. Yet, small businessmen face a constant challenge with respect to the availability of capital. Small businesses simply do not have sufficient access to capital. As a small businessman, I feel that any credible tax reform proposal must simultaneously address this critical situation.

The thinking in the Federal Government is very encouraging at the present time in that there is an attempt to reduce the Federal expenditures, and there are attempts to reduce the maximum rates—to reduce the proposed taxes. Both these things go hand-in-hand as a necessarily desirable effect to free the creative and productive sectors of our society.

I would direct your attention and urge your consideration of the correction in the Tax Code of the bias against private capital. Studies have shown that small business is responsible for nearly all of the job growth of our economy as well as a large part of the development of new ideas and products. The need for private capital exists primarily in manufacturing small businesses. Between $50,000 and $100,000 of capital is required per employee. The startling catalytic effect of this investment of capital can be revealed by putting it in the tax perspective. With good management and a little bit of luck, the $100,000 investment can employ a person for a lifetime. Including corporate and personal and individual tax payments, the Government can receive hundreds of thousands of dollars in taxes as a result of this investment.

There was a survey done by SBANE, and I will quote some numbers from time to time from this survey.

The founding capital of a small business is as follows: It's a family business, 20 percent; owners' savings, 60 percent; outside private individuals, 13 percent. So 90 percent of small businesses start with private capital. As they become established, other sources of capital become available—internally generated, 70 percent; bank loans, 50 percent; investment corporations, 20 percent; outside individuals, 27 percent. So outside private capital and internally generated capital are still very important in the growth of small business.

The taxes which are specifically against private capital, I will not review.

All of the proposals—the President's, Bradley-Gephardt, the Kemp-Kasten—reduce the top marginal rates on both individual and business taxes. This will be beneficial in that it will increase the availability of private individual capital and business capital which is internally generated.

The trend in the administration's two proposals is unfortunate with regard to double taxation of dividends. The first proposal exempted 50 percent; the second exempted only 10 percent. This double taxation has the disadvantage of discouraging equity capital and encouraging borrowed capital. We in business are well aware of the disastrous effects of the cost of servicing fixed debt. Even the Federal Government is becoming painfully aware of this effect, now that the payment of the interest on the debt is a major portion of the deficit. A striking 80 percent of small businessmen surveyed favored the elimination of the double taxation of dividends.

The capital gains tax impacts very heavily on the initial and growth equity financing of small business since the money obtained by selling previous investments is reduced by the capital gains tax. This is very critical at this time, since the entrepreneur is trying to scrape up every penny possible to launch his new venture. Seventy percent of the small businessmen approved modification of the capital gains tax; half favored reduction of the rates, while the other half favored elimination.

Estate and gift tax is not a huge revenue-raiser for the Government. It amounts to only 1 or 2 percent of the annual revenues. However, the catalytic effect previously mentioned also works in the negative way. The removal of $50,000 to $100,000 of equity eliminates a job and the long-term employment of a person and the loss of hundreds of thousands of dollars of tax revenues.

Furthermore, in a large number of cases, the death of a major owner may force an independent small business to be sold to a larger corporation in order to raise the cash required to pay the estate taxes. About 75 percent of the small businessmen surveyed favored modification of the estate and gift taxes as follows: increase the exemption, 32 percent; decrease the rates, 24 percent; eliminate, 20 percent.

Unfortunately, reduction of the estate and gift taxes is not a part of any of the present major tax reform proposals. It would appear appropriate to reduce the maximum transfer tax to a rate equal to the maximum individual tax rate.

There is a critical need for private capital for the formation and growth of small business. The growth of employment in our country is dependent on small business; I hope that Congress, in the difficult task of developing those actions required for tax reform, will consider the catalytic effect of private capital and will reduce or eliminate those taxes which specifically attack capital.

Thank you.

Senator KERRY. Thank you very much, Mr. Stearns.

John Buckley.

STATEMENT OF JOHN S. BUCKLEY, PARTNER, ERNST & WHINNEY, BOSTON, MA

Mr. BUCKLEY. Thank you, Senator.

My name is John Buckley, and I am the partner in charge of tax for Ernst & Whinney in Boston. I an here today to testify as to the summary of a survey that Ernst & Whinney and the Smaller Business Association of New England have recently completed on tax reform proposals.

Today, New England is a region with low unemployment, high growth, and many startup businesses, an area emulated by other sections of the country. Small business and high technology are significant factors in this economy. The companies that drive this economy are affected by tax policies. Ernst & Whinney and SBANE surveyed 1,800 SBANE members and 400 executives of high-technology companies in New England just this April to determine their views on the tax reform proposals present at that time. The survey compares the opinion of 382 respondents who are executives of smaller businesses and high-techology companies in New England with the proposals of Treasury I, Bradley-Gephardt, and Kemp-Kasten.

Responses to the business tax system proposal changes did not reflect a clear-cut support for all, or even most, items of the three tax reform proposals that we present on Capitol Hill at that time. Treasury I, as it has been known, states that "both established industries and new high-technology industries will benefit from tax reform." However, only 42 percent of the survey respondents favor reduction of the corporate tax rate from 46 percent to 33 percent, with elimination of many of the business deductions and credits. There seems to be some uncertainty as to what business deductions and credits will be given up for the rate reduction.

Our survey respondents targeted as their most important business investments R&D expenditures, capital investment in plant and equipment, and training and adding new employees. As a result, 69 percent of all of the survey respondents support extension of the Federal research and experimentation tax credit, which is set to expire at the end of this year. Treasury II extends the research and experimentation credit through 1988 and changes the definition slightly to focus on activities that are likely to produce technological changes and innovations.

The results indicate that New England business executives, regardless of industry, realize the importance of research and development investment in this area. In another area, 66 percent of the respondents supported tax credits for job creation and training. The present targeted jobs tax credit is only available to target employees hired before December 31 of this year. None of the tax reform proposals have addressed the termination of the targeted jobs tax credit, nor do they provide incentives for business to train or add new employees.

Finally, in the capital investment in plant and equipment area, 73 percent of the survey respondents opposed elimination of the investment tax credit. The three tax reform proposals mentioned earlier and the President's Treasury II propose elimination of investment tax credits. The opposition in the survey to this tax reform proposal is not surprising since investment tax credits have been available to businesses since the early 1960's and have risen to the present 10-percent tax credit of the cost of equipment today.

When asked what their primary investment need was, 29 percent of all the executives responding indicated research and development expenses. Among firms who classified themselves as high-tech businesses in New England, 45 percent of these respondents indicated that research and development is its priority for investment. Our respondents supported, by a 4-to-1 margin overall, the extension of the R&D tax credit for businesses. Our survey seems to indicate that New England executives place as much emphasis on R&D as they do on training and additional to new employees, and on capital investment in plant and equipment since all three categories reached on equal result when asked as to selective priority; 29 percent of the survey respondents indicated either R&D, capital investment in plant and equipment, or training and hiring of new employees.

Now, 74 percent of these executives surveyed opposed these proposals to tax employer-paid benefits to employees; 63 percent opposed the specific elimination of any current tax law exclusions for employer-provided group life insurance benefits.

Our survey also requested comments on tax simplification and reform of the individual tax system. All tax reform proposals call for reductions in personal tax rates. Rate reduction was favored by 51 percent of the repondents; however, many other individual tax reform proposals do not enjoy similar support for the survey respondents. An astonishing 80 percent of the respondents oppose elimination of the present treatment of capital gains. Treasury I would have eliminated the differential capital gains taxes; however, Treasury II provides for percent long-term capital gains deduction and a top rate for capital gains for 17.5 percent.

Our respondents seem to view the capital gains treatment as a means of obtaining additional capital investment for their businesses. These businessmen feel that coporate income taxes have already been paid on the earnings of their companies annually. They believe that their equity appreciation should be taxed, but taxed at a rate lower than the ordinary income tax rate. As we know, Treasury II proposes to repeal the deduction by individual taxpayers for State and local taxes. In our survey, 85 percent of the respondents surveyed opposed the proposal to eliminate State and local income taxes as a Federal tax deduction.

In other individual areas, 89 percent of the respondents favor increasing the IRA contribution level to $2,500, and 83 percent of these executives favored the elimination of the double taxation of dividends. Dividends represent, of course, earnings from business which have already been subject to corporate tax. Treasury II provides for a deduction of 10 percent of dividends paid; however, all other tax reform proposals contain no provision for coporate businesses for dividends-paid deductions.

On the subject of individual tax reform, executives, responding to the survey emphasized one consistent theme in the individual area, and that is investment, with support for increasing levels for contributions for IRA's, for retaining the present treatment of capital gains, and even in the area of favoring some type of dividends-paid deduction for corporations.

And its seems that U.S. tax policy has historically been a stimulus for sectors of the economy. And by their answers to this survey, the New England executives seem to reject the notion that it should be otherwise. But company self-interest was not the only motivating force or factor here. In the survey, there is significant across-the-board support for measures that are often thought of as being industry specific. Thus, support for capital investment measures came from the high-technology companies; support for R&D tax credits came from the service business respondents to our survey and other areas of general support. There seems to be, from the survey, a sense that the vitality of these businesses in New England rests on their interdependence with a dynamic economy.

Our survey also sought opinions as to economic expectations, comments as to the Federal deficit, and to the Federal budget, as well. Rather than to go through the detailed results in those areas, we are submitting a copy of our survey results to assist the committee in its efforts to explore the impact of the various tax reform proposals regarding the small business economy in New England.

Thank you.

[The prepared statement of Mr. Buckley follows:]

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WEDNESDAY, JULY 3, 1985
BOSTON, MASSACHUSETTS

U.S. SENATE SMALL BUSINESS COMMITTEE

HEARING ON TAX REFORM PROPOSALS

JOHN S. BUCKLEY
PARTNER

GOOD MORNING LADIES AND GENTLEMEN. MY NAME IS JOHN BUCKLEY AND I AM THE PARTNER IN CHARGE OF TAX FOR ERNST & WHINNEY, BOSTON. ERNST & WHINNEY IS ONE OF THE LARGEST INTERNATIONAL ACCOUNTING FIRMS WITH A TOTAL STAFF OF 23,000 PEOPLE IN MORE THAN 300 OFFICES WORLDWIDE.

TODAY NEW ENGLAND IS A REGION WITH LOW UNEMPLOYMENT, HIGH GROWTH, AND MANY START-UP BUSINESSES. SMALL BUSINESS AND HIGH TECHNOLOGY ARE SIGNIFICANT FACTORS IN THIS ECONOMY. THE COMPANIES THAT DRIVE THIS ECONOMY ARE AFFECTED BY TAX POLICIES. ERNST & WHINNEY AND THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE) SURVEYED 1,800 SBANE MEMBERS AND 400 EXECUTIVES OF HIGH TECHNOLOGY COMPANIES IN NEW ENGLAND JUST THIS APRIL TO DETERMINE THEIR VIEWS ON THE TAX REFORM PROPOSALS PRESENT AT THAT TIME. THE SURVEY COMPARES THE OPINIONS OF 382 RESPONDENTS WHO ARE EXECUTIVES OF SMALLER BUSINESSES AND HIGH-TECH COMPANIES IN NEW ENGLAND WITH THE PROPOSALS OF TREASURY 1, BRADLEY-GEPHARDT, AND KEMP-KASTEN.

RESPONSES TO THE BUSINESS TAX SYSTEM PROPOSAL CHANGES DID NOT REFLECT A CLEAR-CUT SUPPORT FOR ALL OR EVEN MOST ITEMS OF THE THREE TAX REFORM PROPOSALS MENTIONED EARLIER. THE TREASURY REFORM STATES "BOTH ESTABLISHED INDUSTRIES AND NEW HIGH-TECH INDUSTRIES WILL BENEFIT FROM TAX REFORM." HOWEVER, ONLY 42 PERCENT OF THE SURVEY RESPONDENTS FAVOR REDUCTION OF THE CORPORATE TAX RATE FROM 46 TO 33 PERCENT WITH ELIMINATION OF MANY BUSINESS DEDUCTIONS AND CREDITS. THERE SEEMS TO BE SOME UNCERTAINTY AS

TO WHAT BUSINESS DEDUCTIONS AND CREDITS WILL BE GIVEN UP FOR THE RATE REDUCTION. SMALL BUSINESS UNITED HAS ASKED CONGRESS TO REMAIN SENSITIVE TO THE ROLE WHICH GRADUATED CORPORATE TAX RATES PLAY IN FILLING THE VITAL CAPITAL FORMATION NEEDS OF THE SMALLEST AND FASTEST GROWING BUSINESSES. S.B.U. RECOMMENDS A TWO-TIER CORPORATE TAX RATE: HOWEVER, ONLY THE NEW TREASURY II AND THE KEMP-KASTEN PROPOSAL PROVIDE FOR GRADUATED CORPORATE TAX RATES.

SURVEY RESPONDENTS TARGETED AS THEIR MOST IMPORTANT BUSINESS INVESTMENTS R & D EXPENDITURES, CAPITAL INVESTMENT IN PLANT AND EQUIPMENT, AND TRAINING AND ADDING NEW EMPLOYEES. AS A RESULT 69 PERCENT OF THE SURVEY RESPONDENTS SUPPORT EXTENSION OF THE FEDERAL RESEARCH AND DEVELOPMENT TAX CREDIT WHICH IS SET TO EXPIRE AT THE END OF 1985. TREASURY II EXTENDS THE RESEARCH AND EXPERIMENTATION CREDIT THROUGH 1988, AND THE DEFINITION OF QUALIFIED RESEARCH IS REVISED TO FOCUS ON ACTIVITIES LIKELY TO PRODUCE TECHNOLOGICAL INNOVATIONS. THE RESULTS INDICATE THAT NEW ENGLAND BUSINESS EXECUTIVES, REGARDLESS OF INDUSTRY, REALIZE THE IMPORTANCE OF RESEARCH AND DEVELOPMENT INVESTMENT IN THIS AREA. IN ADDITION, 66 PERCENT OF THE RESPONDENTS SUPPORT TAX CREDITS FOR JOB CREATION AND TRAINING. THE PRESENT TARGETED JOBS TAX CREDIT IS ONLY AVAILABLE TO TARGET EMPLOYEES HIRED BEFORE DECEMBER 31, 1985. NONE OF THE PROPOSALS HAVE ADDRESSED THE TERMINATION OF THE TARGETED JOBS TAX CREDIT NOR DO THEY PROVIDE INCENTIVES FOR BUSINESSES TO TRAIN AND ADD NEW EMPLOYEES.

FINALLY, 73 PERCENT OF OUR RESPONDENTS OPPOSE ELIMINATION OF INVESTMENT TAX CREDITS. THE THREE TAX REFORM PROPOSALS MENTIONED EARLIER AND THE PRESIDENT'S TREASURY II PROPOSE ELIMINATION OF INVESTMENT TAX CREDITS. THE 73 PERCENT OPPOSITION OF OUR SURVEY TO THE ELIMINATION OF INVESTMENT TAX CREDITS IS NOT SURPRISING SINCE INVESTMENT TAX CREDITS HAVE BEEN AVAILABLE TO BUSINESSES SINCE THE EARLY 1960'S AND HAVE RISEN TO THE PRESENT-DAY TEN PERCENT TAX CREDIT OF THE COST OF EQUIPMENT.

TWENTY-NINE PERCENT OF ALL EXECUTIVES SURVEYED SHOWS RESEARCH AND DEVELOPMENT AS THEIR PRIMARY INVESTMENT NEED. AMONG FIRMS WHO CLASSIFIED THEMSELVES AS HIGH TECH BUSINESSES, 45 PERCENT OF THESE RESPONDENTS INDICATED R & D AS ITS PRIORITY. OUR RESPONDENTS SUPPORT BY A FOUR-TO-ONE MARGIN THE EXTENSION OF THE R & D TAX CREDITS FOR BUSINESSES. OUR SURVEY INDICATES THAT NEW ENGLAND EXECUTIVES PLACE AS MUCH EMPHASIS ON THE TRAINING AND ADDITION OF EMPLOYEES AS THEY DO WITH CAPITAL INVESTMENT AND R & D, SINCE IT EQUALLED THESE OTHER AREAS AS A SELECTED PRIORITY IN OUR SURVEY. A SURPRISING 66 PERCENT OF THE RESPONDENTS SUPPORT TAX CREDITS FOR JOB CREATION AND TRAINING OF NEW EMPLOYEES. SEVENTY-FOUR PERCENT OF THE EXECUTIVES SURVEYED OPPOSE TAXING EMPLOYER-PAID HEALTH BENEFITS TO EMPLOYEES. SIXTY-THREE PERCENT OPPOSE ANY ELIMINATION OF CURRENT TAX LAW EXCLUSIONS FOR EMPLOYER-PROVIDED GROUP LIFE INSURANCE.

OUR SURVEY ALSO REQUESTED OPINIONS ON TAX SIMPLIFICATION AND THE

INDIVIDUAL TAX SYSTEM. ALL TAX REFORM PROPOSALS, INCLUDING TREASURY II, CALL FOR REDUCTIONS IN PERSONAL TAX RATES. RATE REDUCTION IS FAVORED BY 51 PERCENT OF OUR RESPONDENTS. HOWEVER, MANY OTHER INDIVIDUAL TAX REFORM PROPOSALS DO NOT ENJOY SIMILAR SUPPORT FROM OUR RESPONDENTS. AN ASTONISHING 80 PERCENT OF THE RESPONDENTS OPPOSE ELIMINATION OF THE PREFERENTIAL TREATMENT OF CAPITAL GAINS. TREASURY I WOULD HAVE ELIMINATED PREFERENTIAL CAPITAL GAINS TAXES. HOWEVER. TREASURY II PROVIDES FOR A 50 PERCENT LONG-TERM CAPITAL GAIN DEDUCTION AND A TOP TAX RATE OF 17 1/2 PERCENT FOR GAINS ON STOCKS AND OTHER NON-DEPRECIABLE INVESTMENT PROPERTY. OUR RESPONDENTS PROBABLY VIEW THE CAPITAL GAINS TAX TREATMENT AS A MEANS OF OBTAINING ADDITIONAL INVESTMENT CAPITAL FOR THEIR BUSINESSES. MANY SMALLER BUSINESSES MUST LOOK TO VENTURE CAPITAL FIRMS TO EXPAND THEIR VOLUME OF BUSINESS. IN ADDITION SMALLER BUSINESSMEN CERTAINLY LOOK TO THE OPPORTUNITY TO CASH-IN THEIR BUSINESS AT CAPITAL GAINS TAX RATES WHEN THEIR BUSINESS IS SOLD. THESE BUSINESSMEN FEEL THAT CORPORATE INCOME TAXES HAVE ALREADY BEEN PAID ON THE EARNINGS OF THEIR COMPANY ANNUALLY. THEY BELIEVE THAT THEIR EQUITY APPRECIATION SHOULD BE TAXED, BUT AT A TAX RATE BELOW THAT USED TO TAX ORDINARY INCOME.

TREASURY II PROPOSES TO REPEAL THE DEDUCTION BY INDIVIDUAL TAXPAYERS FOR STATE AND LOCAL TAXES. EIGHTY-FIVE PERCENT OF THE COMPANY EXECUTIVES SURVEYED OPPOSE THE PROPOSAL TO ELIMINATE STATE AND LOCAL INCOME TAX DEDUCTIONS. EIGHTY-NINE PERCENT OF THE RESPONDENTS FAVORED INCREASING THE IRA CONTRIBUTION LEVEL TO $2,500. TREASURY I CONTAINS SUCH A

PROPOSAL; TREASURY II MAINTAINS THE $2,000 MAXIMUM CONTRIBUTION, HOWEVER, IT PERMITS A $4,000 TOTAL WITH A NON-WORKING SPOUSE. EIGHTY-THREE PERCENT OF THE EXECUTIVES SURVEYED FAVOR ELIMINATION OF THE DOUBLE TAXATION OF DIVIDENDS. DIVIDENDS REPRESENT EARNINGS OF A BUSINESS WHICH HAVE ALREADY BEEN SUBJECT TO CORPORATE TAXES. TREASURY II PROVIDES FOR A DEDUCTION FOR TEN PERCENT OF DIVIDENDS PAID. THE OTHER TAX REFORM PROPOSALS CONTAIN NO PROVISION FOR DIVIDENDS-PAID DEDUCTIONS. ON THE SUBJECT OF INDIVIDUAL TAX REFORM PROPOSALS, EXECUTIVES RESPONDING TO OUR SURVEY EMPHASIZED ONE CONSISTENT THEME, THAT IS, INVESTMENT—INCREASING CONTRIBUTION LEVELS FOR INDIVIDUAL RETIREMENT ACCOUNTS, RETAINING PREFERENTIAL TREATMENT OF CAPITAL GAINS, AND A FAVORING OF A DIVIDENDS-PAID DEDUCTION.

U.S. TAX POLICY HAS HISTORICALLY BEEN A STIMULUS FOR SECTORS OF THE ECONOMY. BY THEIR ANSWERS TO THIS SURVEY, EXECUTIVES REJECT THE NOTION THAT IT SHOULD BE OTHERWISE. BUT COMPANY SELF-INTEREST IS NOT THE ONLY MOTIVATING FORCE HERE. IN THIS NEW ENGLAND SURVEY, THERE IS SIGNIFICANT ACROSS-THE-BOARD SUPPORT FOR MEASURES THAT ARE OFTEN THOUGHT OF AS BEING INDUSTRY-SPECIFIC. THUS, SUPPORT FOR CAPITAL INVESTMENT MEASURES COMES FROM HIGH TECH COMPANIES, SUPPORT FOR R & D TAX CREDITS COMES FROM A MAJORITY OF THE SERVICE FIRMS RESPONDING, AND SO ON. THERE IS A SENSE THAT THE VITALITY OF THESE BUSINESSES IN NEW ENGLAND RESTS ON INTERDEPENDENCE WITH A DYNAMIC ECONOMY.

OUR SURVEY ALSO SOUGHT EXECUTIVES' OPINIONS AS TO ECONOMIC EXPECTATIONS, THE FEDERAL DEFICIT, AND THE FEDERAL BUDGET.

WE ARE SUBMITTING A COPY OF OUR SURVEY RESULTS TO ASSIST THE COMMITTEE IN ITS EFFORTS TO EXPLORE THE IMPACT OF THE VARIOUS TAX REFORM PROPOSALS REGARDING THE SMALL BUSINESS ECONOMY IN NEW ENGLAND.

EXHIBIT I

TAX POLICY FOR ECONOMIC VITALITY: A LEADERSHIP SURVEY OF SMALL BUSINESS AND HIGH TECHNOLOGY COMPANIES IN NEW ENGLAND

The Smaller Business Association
of New England
Waltham, Massachusetts

Ernst & Whinney
Boston, Massachusetts

May 8, 1985

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INTRODUCTION

New England today is a region with low unemployment, high growth and new business start-ups. Small business and high technology are significant factors in this economic picture. High technology, along with the region's solid manufacturing base and service industries, transformed the region's economy in the first part of the 1980s.

The New England economy, like that of California's Silicon Valley, is one that other regions of the U.S. and the world are trying to imitate. The companies that drive this economy are affected by public policies, particularly tax policies, that can stimulate investment and economic vitality. This survey of members of the Smaller Business Association of New England and of executives of high technology companies presents some of their views on economic conditions and tax policy. The results send an important message to government policy-makers.

TAX POLICY FOR ECONOMIC VITALITY: A LEADERSHIP SURVEY OF SMALL BUSINESSES AND HIGH TECHNOLOGY COMPANIES IN NEW ENGLAND was a joint project of the Smaller Business Association of New England (SBANE), headquartered in Waltham, Massachusetts, and Ernst & Whinney, Boston.

HIGHLIGHTS AND CONCLUSIONS

This survey was administered in March/April 1985 by direct mail to 1800 members of the Smaller Business Association of New England and 400 chief financial officers of companies that are members of the Massachusetts High Technology Council. In all, 382 completed questionnaires were returned, a response rate of about 17.5 percent.

Ninety-five percent of the respondents are officers of their companies, partners in their firms, proprietors of their own businesses, or managers in their companies. Their companies are in the high technology, manufacturing, wholesale/retail distribution, and service industries.

Executives of these 382 smaller businesses and emerging high technology companies are confident about the prospects for growth of their own companies and for the U.S. economy. About half of respondents expect growth of eleven percent or more in their company's 1985 pre-tax income over that of 1984. Eight in ten voice optimism about the U.S. economy over the next four years. This includes the nearly universal expectation that the inflation rate will be at ten percent or below.

A striking 90 percent of these executives view the federal deficit as a serious problem, and about three in four say it must be dealt with immediately. A majority of respondents disagree that the economy can simply outgrow the deficit.

A second key finding is that, in principle, more of these executives favor cuts in defense spending (74 percent) than favor cuts in social programs (63 percent).

A significant finding with major implications is that 72 percent of respondents say Congress should be required to develop a balanced federal budget.

When it comes to the revenue raising side of the equation, slightly more executives oppose increasing personal tax revenues (60 percent) than oppose increasing business tax revenues (57 percent).

Specific business tax proposals:

- Slightly more respondents oppose a new business tax system that would reduce the top corporate rate from 46% to 33% and eliminate many business deductions (36 percent oppose) than oppose the current system (30 percent oppose).
- A 73 percent majority favor Small Business Participating Debentures.
- Surprisingly, equal proportions of respondents identify their most important priority for investment as R&D (29 percent), capital investment (30 percent), and employee training/additions (30 percent).
- 73 percent favor Investment Tax Credits.

- Only 17 percent say a one-year accelerated depreciation write-off would stimulate capital investment by a very great degree.
- 69 percent favor extension of R&D Tax Credits, and this rises to 84 percent of companies that target R&D investment as their most important priority.
- 66 percent favor extension of tax credits for job creation and training.
- 48 percent of executives oppose reducing business entertainment deductions, but a surprising 34 percent favor reducing them.
- 71 percent oppose a value added tax. Opposition is clear-cut among both smaller and larger companies.
- Import taxes are opposed by 45 percent, with 37 in favor.
- Majorities oppose unitary taxes calculated on the basis of world-wide income (64 percent) or U.S. income (55 percent). Even among companies with fewer than ten employees, a 55 percent majority oppose unitary taxes.
- If there is to be a unitary tax system, respondents would favor a consistent federal system by 50-20 percent.

It is striking that job creation and training, R&D investment and investment in capital plant and equipment are emphasized equally by these executives.

Also striking is the across-the-board majority support for R&D tax credits and for tax credits for job creation and training -- both due to expire at the end of 1985 unless renewed by Congress.

Other major findings are the strong opposition to the elimination of business investment tax credits, to a value added tax, and to unitary taxation.

That about one in three executives would favor reducing business tax deductions is a surprise, as is the finding that fewer than one in five say a one-year ACRS write-off would stimulate their company's capital investment by a very great degree.

Individual Tax Measures:

- 51 percent favor individual tax simplification that would reduce the total number of brackets to three. Twenty-four percent oppose this.
- 70 percent reject a "fast tax".
- By 49-35 percent, respondents oppose a "flat tax".
- 74 percent oppose taxing employer-paid health benefits as personal income.
- 70 percent oppose repealing favorable treatment of pension contributions and distributions.
- 63 percent oppose eliminating exclusions for employer-provided group life insurance.
- 89 percent would raise I.R.A. contributions level to $2,500.
- 85 percent oppose eliminating deductions for state and local taxes.

- 83 percent favor eliminating double taxation of dividends.
- A striking 80 percent oppose eliminating preferential treatment of capital gains.
- By 52-35 percent, respondents oppose eliminating mortgage deductions for second homes.
- By 55-17 percent, they oppose eliminating deductions for interest payments which exceed investment income by more than $5,000.
- By 49-33 percent, they oppose permitting deductions for charitable contributions only if these exceed two percent of adjusted gross income.

That such sizeable majorities of executives oppose elimination of federal income tax deductions for state and local taxes and elimination of preferential treatment of capital gains is significant.

Their commitment to training and adding employees is reflected in attitudes toward taxing as income employee health benefits, eliminating exclusions for employer-paid group life insurance, and even repealing favorable treatment of pension contributions and distributions.

The one consistent theme that flows through the executives' attitudes on business and individual income tax measures is that of economic investment -- investing in the R&D, capital, and people it will take to achieve the growth their companies are aiming for.

On the subject of individual tax measures, these executives also emphasize investment -- increasing contributions levels for Individual Retirement Accounts and retaining preferential treatment of capital gains.

U.S. tax policy has historically been a stimulus for sectors of the economy. By their answers to this survey, executives reject the notion it should be otherwise. But, company self-interest is not the motivating force here. There is significant across-the-board support for measures that are often thought of as being industry-specific. Thus, support for capital investment measures comes from high tech companies, support for R&D tax credits comes from a majority of service firms, and so on. This describes a sense that the vitality of these businesses rests on interdependence within a dynamic economy.

MAJOR FINDINGS

ECONOMIC EXPECTATIONS, FEDERAL DEFICIT, AND FEDERAL BUDGET

EXPECTATIONS FOR COMPANY GROWTH:

Whatever their business's current level of sales, these executives voice confidence in their company's growth, as measured in expected growth of 1985 pre-tax income over 1984 pre-tax income.

Twenty-five (25) percent expect growth of more than 21%.

Twenty-five (25) percent of the respondents foresee growth of 11-20%.

Twenty-four (24) percent forecast growth of 6-10%.

Twenty-four (24) percent anticipate growth of 0-5%.

Anticipated Growth in Pre-Tax Income During 1985:

Anticipated Growth	Number in Sample	Percent of Sample
Zero - 5%	91	23.8
6 - 10%	90	23.6
11 - 20%	96	25.1
21 - 30%	49	12.8
31 - 40%	9	2.4
41 - 50%	7	1.8
More than 50%	32	8.4

Expected growth varies significantly by industry. High tech and service companies are forecasting higher growth this year than manufacturing and distribution companies.

Among high tech companies:

- 39 percent expect growth of 21% or more;
- 24 percent forecast growth between 11-20%.

Among service companies:

- o 26 percent anticipate growth of 21 percent or better;
- o 31 percent forecast growth of between 11-20%.

Among manufacturing companies:

- o 34 percent expect growth of 0-5%;
- o 24 percent expect growth between 6-10%.

Among distribution companies:

- o 67% expect growth of 0-10% this year.

EXPECTATIONS FOR THE U.S. ECONOMY:

The optimism that small businesses and high tech companies show about their own growth is echoed in their view about the nation's economy, but this optimism is tempered by caution.

Eighty-three (83) percent of these executives voice optimism about prospects for the U.S. economy over the next four years. Twelve (12) percent of the respondents describe themselves as very optimistic, and 71 percent say they are somewhat optimistic.

Among manufacturing executives, there is a higher degree of pessimism about prospects for the economy, with 22 percent describing themselves as very or somewhat pessimistic.

Similarly, about 22 percent of companies ranging in size from $5-25 million in sales, express some degree of pessimism about the economy.

Inflation Rate:

In a key finding, a 95 percent majority of companies expect the inflation rate to stay at 10% or below for the next four years. In fact, ten (10) percent of respondents forecast an inflation rate of less than 4%. This view does not vary much by company type, size, or industry.

Prime Rate:

As for the prime rate, 84 percent of respondents expect this to be between 11-15% during the next four years.

Ten (10) percent anticipate a prime rate below 10%. Among manufacturing companies, 15 percent expect a prime rate below 10%.

Only about four (4) percent of the respondents say the prime will reach above 16%.

FEDERAL DEFICIT:

A striking 90 percent of these executives view the federal deficit as a serious problem.

An 83 percent majority oppose 'doing nothing' to reduce the deficit.

A 73 percent majority say the federal deficit must be dealt with immediately.

Thinking, perhaps, this is a problem with no quick or easy solutions, 52 percent view the deficit as a problem to be dealt with over time.

However optimistic they are about the economy and their own company's growth, these small business and high tech executives disagree, by 54 to 28 percent, that with proper stimulus the U.S. economy can outgrow the deficit. High tech companies are more likely to think it can, but still disagree by 46-35 percent. There is uncertainty on this issue, with 18 percent of the total sample saying they are simply not sure.

Deficit Reduction:

Just how deficit reduction should be achieved -- through spending cuts, revenue raising, or a combination of these -- is a central question.

Fifty-three (53) percent of the companies favor a combination of spending cuts and increased taxes to reduce the deficit. In general, respondents show far more support for spending cuts than for increasing individual or business taxes.

A striking 74 percent majority of these executives favor defense spending cuts, compared to 63 percent that favor cuts in social programs. In general, the larger the company (measured in number of employees and sales volume), the more support there is for cutting social programs. Sixty-nine (69) percent of high tech companies support cuts in social programs. Cuts to reduce government waste have virtually unanimous support.

On the revenue raising side of the equation, respondents oppose raising personal tax revenues by a 60 percent majority, compared with 57 percent that oppose raising business tax revenues. In each case, about 20 percent say they oppose and 20 percent say they neither favor nor oppose these measures.

There are some variations on the issue of raising business tax revenues. Among companies employing 101 or more people and with over $25 million in annual sales, about 65 percent of respondents oppose raising business tax revenues. Among companies employing from 26-100 people and companies in the service industry catagory, about half oppose this.

A BALANCED FEDERAL BUDGET:

A key finding with significant implications is that a 72 percent majority of these business executives agree that Congress should be required to develop a balanced federal budget. Only 15 percent of respondents disagree with this.

Even among larger companies with more than 100 employees and sales over $25 million, about two-thirds of the respondents agree that Congress should balance the budget.

SPECIFIC TAX POLICIES

Respondents were asked whether they favor, oppose or neither favor nor oppose various tax proposals currently on Capitol Hill and tax measures proposed by then-Treasury Department Secretary Donald Regan in the fall of 1984. These proposals span a range of business and individual tax issues.

A 37-25 percent plurality of executives oppose reducing by 10% or 20% total actual individual or business deductions.

REVAMPING THE BUSINESS TAX SYSTEM:

There is no strong support for revamping the business tax system by reducing the top corporate rate and eliminating deductions. In fact, there is quite a bit of ambivalence about this issue, and slightly more respondents oppose the new system than oppose the current system.

Uncertainty about what deductions will be eliminated may color current viewpoints on this issue.

Forty-one (41) percent favor, 30 percent oppose, and 26 percent neither favor nor oppose keeping the current business tax system, i.e., 46% business tax rate with deductions.

Forty-two (42) percent favor, 36 percent oppose, and 20 percent neither favor nor oppose reducing the top corporate rate from 46% to 33% and eliminating many business deductions.

By 79-11 percent, companies oppose increasing the business tax burden by the 25% anticipated under the Treasury Department proposal.

GROWTH CAPITAL:

A 61 percent majority of these companies say they look to internally generated funds as their major source of growth capital.

Most Important Source of Growth Capital for Company:

Source	Number	Percent
Internally Generated	231	60.5
Bank Loans	110	28.8
Investment Corporation	5	1.3
Outside Individuals	10	2.6
Other	15	3.9
Not Applicable	10	2.6

Yet in addition to internally generated funds, company executives send a clear signal on the tax policies that will support their businesses.

SMALL BUSINESS PARTICIPATING DEBENTURES:

A 73 percent majority of respondents favor Small Business Participating Debentures that allow capital to be invested in small business at favorable tax rates.

This measure is supported by 82 percent of companies with 11-25 employees and 77 percent of high tech companies. Even among larger companies (with over $25 million in sales), three out of four respondents support this.

PRIORITIES FOR COMPANY INVESTMENT:

Respondents were asked to target their single most important priority for investment -- research and development, capital investment (plant and equipment), or training/adding employees.

Somewhat surprisingly, the number of companies that targeted each area is virtually identical:

- o 29 percent of all the company executives view research and development as their single most important priority for investment,
- o 30 percent emphasize renewal of capital plant or replacement of machinery and equipment, and
- o 30 percent indicate employee training or adding employees as their priority.

Perhaps most significant is the emphasis these executives place on employee training and adding employees.

One Area That is Single Priority for Investment:

Single Priority	Number	Percent
Research & Development	110	28.8
Renewing Capital Plant	37	9.7
Replacing Machinery Equipment	78	20.4
Employee Training	37	9.7
Adding Employees	78	20.4
Not sure	34	8.9

Among high technology companies:

- o 45 percent target R&D,
- o 29 percent identify employee training/additions, and
- o 16 percent say capital investment is their chief priority.

Among manufacturing companies:

- o 54 percent place an emphasis on capital investment,
- o 28 percent on R&D, and
- o ten percent on employee training/additions.

Among service companies:

- 46 percent point to employee training/additions,
- 25 percent to R&D, and
- 19 percent to capital investment,

Among wholesale and retail distribution companies:

- 42 percent target employee training/additions,
- 36 percent cite capital investment, and
- seven percent indicate R&D, as their single priority for investment.

BUSINESS CAPITAL INVESTMENT:

Aged plant and equipment is a concern in New England as elsewhere. As indicated above, capital investment -- whether renewing capital plant or replacing machinery or equipment -- is a top investment priority for 30 percent of the company executives. Fifty-four (54) percent of manufacturing concerns say so, as do 36 percent of wholesale and retail distribution companies, 19 percent of service firms, and 16 percent of high tech companies.

Investment Tax Credits:

A striking 73 percent majority of these small business and high tech executives oppose elimination of business investment tax credits.

Among high tech respondents and those who identify investment in R&D as their single most important priority, 76 percent oppose elimination of investment tax credits.

Major tax reform proposals in Congress would eliminate investment tax credits.

Industrial Revenue Bonds:

A 57 percent majority of respondents favor Long-term Industrial Bond Borrowing at less than the prime rate. Twenty-three (23) percent oppose this measure.

By 52-28 percent, companies oppose eliminating private purpose industrial revenue bonds.

Accelerated Depreciation:

A 58 percent majority of these executives favor gearing accelerated depreciation allowances to the life of an asset.

This majority increases with the size of the company: about two-thirds of companies with more than 101 employees and with over $25 million in sales support this measure.

About two-thirds of high tech companies and companies that target R&D as their priority for investment favor this measure.

One Year ACRS Write-Off:

When asked to what degree a one-year write-off Accelerated Cost Recovery System (ACRS) would stimulate their company's capital investment, a surprisingly low 17 percent of all companies indicate it would influence them by a very great degree.

Thirty-five (35) percent say it would to some degree, and 28 percent say to a very slight degree. Eighteen percent say a one-year ACRS write-off would not stimulate their investment at all.

Of the companies that identify capital investment as their single most important priority, 23 percent indicate this measure would stimulate their investment to a very great degree and 39 percent say it would to some degree.

Among manufacturing companies, 58 percent say this measure would stimulate investment to a very great or some degree.

Direct Expensing of Assets:

By 49-15 percent (with a high 34 percent that neither favor nor oppose), companies favor direct expensing of assets up to $25,000 a year. A 54 percent majority of companies with sales of over $25 million favor this measure, as do 53 percent of high tech companies.

Indexing Depreciated Assets:

Company executives favor, by 45-19 percent, indexing depreciated assets to relieve taxpayers during inflationary periods. A high 35 percent of the company executives neither favor nor oppose this measure.

Used Equipment Tax Credit:

Increasing the used equipment tax credit to $500,000 does not receive the same level of support as other capital investment measures. Forty-one (41) percent of companies favor this measure, while 19 percent oppose, and 38 percent neither favor nor oppose it.

INVESTMENT IN RESEARCH AND DEVELOPMENT ACTIVITIES:

R&D investment is targeted as the major priority of 29 percent of the companies. It is cited by 45 percent of high tech companies, 28 percent of manufacturing companies, 25 percent of service companies, and seven percent of distribution companies as their single most important area of investment.

R&D Tax Credit:

The federal R&D tax credit is set to expire at the end of 1985. This provision allows for a 25% tax credit for increases in qualified research spending over an average of this spending for three preceeding years.

By 69-17 percent, a significant across-the-board majority of company executives support the extension of R&D tax credits.

Among companies that identify R&D as their single priority for investment, 84 percent support this measure, as do 76 percent of companies in the high tech industry catagory.

Seventy-three (73) percent of companies with 11-25 employees and with 101 or more employees support extension of R&D tax credits, as do 81 percent of companies with sales between $10-24.9 million.

A 71 percent majority of service companies support this measure. Even among distribution companies, a 51 percent majority supports extension of R&D tax credits.

BUSINESS INVESTMENT IN PEOPLE:

One of the key findings here is the emphasis these New England executives place on the training and addition of employees. Among all companies, this is a priority equal to capital investment and R&D investment.

Investment in training and adding employees is cited as the top priority for investment by 29 percent of high tech companies, ten percent of manufacturing companies, 46 percent of service firms, and 42 percent of wholesale and retail distribution companies.

Tax Credits for Job Creation and Training:

A 66 percent majority of company executives favor tax credits for job creation and training. Only 17 percent oppose this measure.

Current tax credits for job creation and training are due to expire at the end of 1985 unless renewed by Congress.

Support for extension of these tax credits rises to 75 percent of partnership businesses, 76 percent of companies employing between 11-25 people, 74 percent of companies with sales between $10-24.9 million, 68 percent of companies that identify R&D as their priority for investment and of high tech companies, and 64 percent of manufacturing companies.

OTHER BUSINESS TAX POLICIES:

Business Entertainment Deductions:

Forty-eight (48) percent of the company executives oppose reducing business entertainment deductions, but a rather surprising 34 percent favor this. Eighteen (18) percent neither favor nor oppose this.

Opposition to reducing business entertainment deductions reaches majority proportions among companies that are sole proprietorships, partnerships, have 10 or fewer employees, have sales between $10-24.9 million, and that are in the wholesale/retail/distribution industry.

Among companies with sales of over $25 million, 49 percent of respondents favor reducing business entertainment deductions.

Value Added Tax:

A 71 percent majority of companies oppose a "value added tax" (VAT) that would add a tax at every production and distribution point until products reach the consumer.

There is clear-cut opposition to VAT by both smaller and larger companies. Among companies with ten or fewer employees, 79 percent of the respondents oppose this measure, as do 63 percent of respondents among companies with 101 or more employees and with sales of more than $25 million.

Import Taxes:

Taxes on imports into the U.S., such as a Temporary Import Surcharge or a Business Transfer Tax, are opposed by a 45-37 percent plurality of the companies.

A 57 percent majority of high tech companies and companies that target R&D as their single most important priority for investment oppose these taxes on imports.

However, a 53 percent majority of wholesale and retail distribution companies favor such taxes.

Unitary Taxation:

Various states have enacted "unitary taxes" that tax corporations doing business in the state on the basis of income earned outside the state. In Massachusetts, the Commonwealth's unitary tax (calculated on the basis of world-wide income) was recently challenged and struck down in court.

When asked about various approaches to unitary taxes, companies clearly oppose these systems in general, but favor a federal system to a multiplicity of state laws. However, about one in five companies say they neither favor nor oppose each of these unitary tax approaches.

By 64-7 percent, companies oppose a unitary tax calculated on the basis of total world-wide income.

They also oppose, by 55-13 percent, a unitary tax calculated on the basis of total U.S. income.

Opposition to unitary taxes is strongest among companies with 101 or more employees in the New England region and among companies with sales of $10-24.9 million. But even among companies with ten or fewer employees, unitary taxation is opposed by a 55 percent majority.

A substantial 73 percent of high tech companies are opposed to unitary taxation on the basis of world-wide income.

If some form of unitary taxation is destined, 50 percent of respondents favor a consistent federal system to a multiplicity of state systems. Sixty-five (65) percent of companies with 101 or more employees favor a federal approach, as do 71 percent of companies with over $25 million in sales.

Among those 80 companies (21 percent of all respondents) that indicate state taxes are a major factor in their business planning, a 69 percent majority oppose unitary taxation calculated on the basis of world-wide income, and a 60 percent majority oppose unitary taxation on the basis of total U.S. income. By 46-35 percent, these companies also favor a federal system over a variety of state systems.

INDIVIDUAL TAXATION:

By a narrow 40-37 percent, with 22 percent neither favoring nor opposing, the executives oppose reducing the individual tax burden by the 8.5% anticipated under the Treasury Department plan. Among companies with sales over $25 million, 51 percent oppose this. Support is highest among sole proprietorships, with 48 percent in favor.

Tax Simplification:

There is a striking amount of support for individual tax simplification -- reducing the number of individual tax brackets from 16 to three (3) brackets (10%; 15%; 35%). This is favored by 51 percent of the sample, opposed by 24 percent and neither favored nor opposed by 25 percent.

However, other specific proposals for tax simplification do not attract this support. By 49-35 percent, the executives oppose a "flat tax", i.e., one tax rate no matter what the personal income, with no personal deductions.

"Fast Tax":

By 70-14 percent, company executives reject a "fast tax" system, i.e., a graduated income tax that would tax higher incomes at much higher levels.

Taxing Employee Benefits as Personal Income:

On the volatile question of taxing employee benefits, a substantial 74 percent of the companies oppose taxing as personal income employer-paid health benefits.

This compares to 63 percent that oppose eliminating exclusions for employer-provided group life insurance.

Seventy (70) percent oppose repealing favorable treatment of pension contributions and distributions, such as ten-year averaging of lump sum distributions to retiring employees.

I.R.A. Contributions:

An 89 percent majority of the company executives favor raising the Individual Retirement Account contribution level to $2,500.

Deductions for State and Local Taxes:

A significant 85 percent majority of company executives oppose eliminating deductions for state and local taxes. Only seven percent favor this.

Double Taxation of Dividends:

By a substantial 83-10 percent, company executives favor eliminating 'double taxation' of dividends.

Capital Gains:

An astonishing 80 percent majority of respondents oppose eliminating preferential treatment of capital gains. Ten percent oppose, and ten percent neither favor nor oppose this measure.

Mortgage Deductions for Second Homes:

Company executives oppose by 52-35 percent eliminating deductions for mortgages on second homes.

Deductions for Interest Payments:

By 55-17 percent, company executives oppose eliminating deductions for interest payments if these payments exceed investment income by more than $5,000.

Charitable Contributions:

By 49-33 percent, executives oppose permitting charitable deductions only if contributions exceed 2% of adjusted gross income.

Taxing Unemployment Benefits:

The companies are divided on allowing only partial exclusion of unemployment benefits, with 38 percent opposing, 36 percent favoring, and 24 percent saying they neither favor nor oppose this measure.

METHODOLOGY

The survey was administered by direct mail to members of the Smaller Business Association of New England (SBANE) and members of the Massachusetts High Technology Council.

Survey questionnaires were mailed to chief executives of 1800 SBANE companies and chief financial officers of 400 High Tech Council companies on March 27, 1985.

Respondents were asked to return completed questionnaires by April 5, 1985.

In all, 382 completed questionnaires were received by April 15. This represents an overall response rate of 17.5 percent.

Survey results were recorded and tabulated by an independent survey research firm, Strawberry Systems, Inc., of Watertown, Massachusetts.

Percentages may not add to 100 because of rounding.

ABOUT THE SAMPLE

The 382 New England companies that responded to this survey include service businesses, wholesale and retail distribution, manufacturing and high technology companies. For analytical purposes, respondents were grouped into several industry classifications:

- 23 percent, or 87 companies, are classified as high tech companies (computers, electronics, biotechnology, etc.).
- 27 percent are manufacturing companies.
- 12 percent are in distribution, wholesale and retail.
- 31 percent of the sample represent service industries. (public relations, advertising, publishing, accounting, other financial services, law, medicine, management consulting, etc.)

Ninety-five (95) percent of the survey respondents are officers of their companies, partners in their firms, proprietors of their own businesses, or managers in their companies. Among firms employing more than 101 people in New England and among companies with sales revenues of $25 million and over, about 80 percent of respondents are officers in their companies.

Sixty-one (61) percent of the respondents anticipate their company's sales volume in 1985 will be less than $5 million. Twenty-eight (28) percent of the executives place sales between $5-24.9 million, and nine (9) percent at over $25 million.

Twenty-seven (27) percent of these companies employ ten or fewer people in the New England region, 18 percent employ 11-25 people, and 33 percent employ 26-100 people. Twenty-three (23) percent employ more than 101 people. Thus, respondents were about evenly distributed over all company size catagories.

The vast majority of the businesses in the sample -- 86 percent, or 328 businesses in all -- are incorporated.

The following tables describe the survey sample:

Catagcry	Number in Sample	Percent of Sample
Industry/Chief Line of Business:		
Manufacturing	104	27.2
High Technology/R&D (Computer, Electronics)	87	22.8
Distribution Wholesale/Retail	45	11.8
Advertising/Public Relations/Publishing	24	6.3
Professional Services (Law, et al)	18	4.7
Finance/Accounting Insurance/Venture Capital	62	16
Medical	14	3.7
Construction	7	1.8
Other	4	1.0
Respondent's Position:		
Officer of Company	274	71.7
Proprietor	81	21.2
Partner	39	10.2
Manager	60	15.7
Other	20	5.2
Company Sales Volume:		
Less than $5 million	235	61.4
$5 - 9.9 million	63	16.5
$10 - 24.9 million	43	11.3
$25 million and over	35	9.2
Number of People Company Employs in New England:		
10 or less	103	26.9
11 to 25	67	17.5
26 to 100	124	32.5
101 and more	87	22.8
Type of Organization:		
Corporations	304	79.6
Sole Proprietorship	29	7.6
Sub-chapter S Corporations	24	6.3
Partnership	20	5.2

ABOUT THE SURVEY SPONSORS

ERNST & WHINNEY:

Ernst & Whinney is one of the world's largest international firms of independent public accountants and consultants. The firm has more than 350 offices world-wide. New England offices include Portland, Maine; Manchester, New Hampshire; Providence, Rhode Island; Hartford and New Haven, Connecticut; and Boston, Massachusetts.

Ernst & Whinney Boston is the Northeast Regional headquarters of the firm. Its 220 professionals specialize in tax, audit and management consulting services to clients ranging from privately-owned and emerging businesses to some of the largest companies in the region.

THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE):

SBANE is the nation's oldest regional small business association. It is a private, non-profit, non-partisan association serving 2,000 members. It concentrates on education for the entrepreneur and legislative advocacy on the federal level.

SBANE is committed to fostering the growth of the nation's small businesses, which comprise 97 percent of all business entities, employ 55 percent of the workforce, and generate 40 percent of the U.S. Gross National Product.

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SUMMARY TABLE

INDIVIDUAL INCOME TAX POLICY

Proposal	Percent Favor	Percent Neither Favor/ Oppose	Percent Oppose
Reduce Individual Tax Burden by 8.5%	37	22	40
Go from 16 brackets to three	51	25	24
"Flat Tax"	35	14	49
"Fast Tax"	14	14	70
Tax Employer-paid Health Benefits as Personal Income	18	8	74
Eliminate Exclusions for Employer-provided Group Life Insurance	20	17	63
Repeal Favorable Treatment of Pension Contributions and Distributions	12	16	70
Raise I.R.A. Contribution Level to $2,500	89	7	4
Eliminate Deductions for State and Local Taxes	7	7	85
Eliminate Preferential Treatment of Capital Gains	10	10	80
Eliminate Mortgage Deductions for Second Home	35	12	52
Eliminate Deductions for Interest Payments of Less Than Investment Income Plus $5,000	17	25	55
Permit Charitable Deductions Only if They Exceed 2% of Adjusted Gross Income	33	18	49
Allow Only Partial Exclusion for Unemployment Benefits	36	24	38

SUMMARY TABLE

BUSINESS TAX POLICY

Proposal	Percent Favor	Percent Neither Favor/ Oppose	Percent Oppose
Corporate Rate of 46% with Deductions	41	26	30
Corporate Rate of 33% But Eliminate Many Deductions	42	20	36
Increase Business Tax Burden by 25%	11	10	79
Small Business Participating Debentures	73	14	12
Eliminate Investment Tax Credits	14	13	73
Industrial Revenue Bond Borrowing Less than Prime	57	19	23
Eliminate Private Purpose Industrial Revenue Bonds	28	19	52
Gearing Accelerated Depreciation to Life of Asset	58	22	19
Direct Expense Assets up to $25,000	49	34	15
Indexing Depreciated Assets	45	35	19
Increase Used Equipment Tax Credit to $500,000	41	38	19
R&D Tax Credit	69	13	17
Tax Credits for Job Creation and Training	66	16	17
Reducing Business Entertainment Deductions	34	18	48
Value Added Tax	13	14	71
Import Taxes	37	17	45
Unitary Tax/World-wide Income	7	22	64
Unitary Tax/U.S. Income	13	25	55
Consistent Federal Unitary Tax	50	23	20

Price Waterhouse
BUSINESS REVIEW
A newsletter
for smaller businesses and entrepreneurs
designed to provide
accurate and helpful information

Survey Reveals National Priorities of U.S. Smaller Businesses—Payroll Taxes and Federal Spending Lead List

Relief from rising payroll taxes and cuts in federal spending lead the small business community's list of public policy priorities, according to an informal survey recently conducted by Price Waterhouse's National Office of Smaller Business Services. This list was developed at a Small Business National Issues Conference (SBNIC), sponsored by the American Institute of Certified Public Accountants, the National Federation of Independent Business, the National Small Business Association, Small Business United, and the U.S. Chamber of Commerce. Over 100 small business executives representing 5 million small business members of these organizations met at the conference, held last June in Washington, D.C. The conference identified 25 priority issues and proposed about 80 related actions. *Business Review* readers were asked to respond to these. The Price Waterhouse survey produced 874 usable responses from a broad cross-section of smaller businesses.

Payroll Taxes

"Payroll taxes have a disproportionate impact on small business," according to a conference report, "because small firms are generally labor intensive and a larger portion of their total payroll is subject to these taxes." It is estimated that payroll taxes now provide 33 percent of federal revenues. The growth in payroll taxes, however, was considered perhaps even more significant. Between 1970 and 1990, 9 Social Security rate increases totalling 60 percent, 19 Social Security base increases amounting perhaps to 677 percent, 3 federal unemployment tax (FUTA) rate increases amounting to 94 percent, and 3 FUTA base increases adding up to 133 percent have occurred or are scheduled. In the view of the conference, "payroll taxes must become part of the broad tax policy debate. Despite immediate as well as long-term problems of funding Medicare, Social Security, and unemployment compensation reserves, Congress must be convinced that the small business community can no longer support this continuing upward spiral." About 82 percent of respondents to the survey opposed any further increases in payroll taxes.

Asked about the relationship between payroll taxes and economic growth, 79 percent of the respondents felt that it does not make sense to use total employment as a tax base. They agreed with a conference report that "financing government spending by raising taxes on employees artificially discourages the hiring of people by making them more expensive relative to equipment." More generally, the great majority (88 percent) of respondents felt that the government should avoid policies that distort the free market, such as subsidies and penalties that handicap some types of economic activity, such as labor-intensive smaller business. It was noted that "recent research recognizes that smaller enterprises are a major resource that must be considered as a significant partner" in pursuing the nation's economic and social goals.

Much of the concern about payroll taxes focused on unemployment compensation. The June 1984 conference expressed an interest in controlling unemployment compensation costs and in setting the level of unemployment benefits to provide subsistence rather than income maintenance. Three proposals received particularly strong support from survey respondents. First, the individual states should move to control cost increases by improving experience rating and targeting benefits. Second, proposed legislation to defer or forgive repayment of federal loans should be opposed. Third, Congress should pass legislation to exempt employers from paying unemployment taxes for employees who are never eligible for benefits, such as corporate officers.

Also in this Issue. . .

- **Federal Technology Help**
- **Taxing Cars & Computers**

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Finally, survey respondents favored changes in Internal Revenue Service (IRS) regulations, designed to ease the burden of payroll taxes on small firms while in no way reducing the responsibility of the business owner. In particular, it was felt that IRS notification of penalty and taxes past due should include a detailed account of computations. Some 85 percent supported this proposal.

Federal Spending and the Deficit

While Americans apparently agree that federal spending should be cut, there seem to be major differences of opinion on how this can be done. Many in Congress feel that entitlements (e.g., Social Security) and military programs provide the only remaining opportunities for major savings. The Small Business National Issues Conference and results of the Price Waterhouse survey indicate, however, a widespread belief that there is simply a lot of waste and, hence, potential savings throughout government.

"Small business supports intensive effort to eliminate government inefficiency and waste," the conference reported. The President's Commission on Cost Containment (Grace Commission), which has offered recommendations for eliminating what it sees as significant waste, aroused the interest of participants. The conference suggested that "these savings can be effected with and without legislation and could significantly reduce the Federal budget deficit." Over 87 percent of survey respondents favored implementation of appropriate Grace Commission proposals. There was considerable support for a specific implementation program. At least 76 percent of the respondents favored each of three proposed steps. First, the President should direct affected departments and agencies to take appropriate administrative action to implement cost saving recommendations and report on their progress by August 31, 1985. Second, the Office of Management and Budget should monitor the implementation plans of the departments and agencies, and suggest appropriate steps to accomplish the intent of the recommendations. Third, Congress should review the Grace Commission report and report appropriate implementing legislation by August 31, 1985.

A majority of respondents favored various approaches toward curbing government spending, such as permanently adjusting cost of living adjustments to less than consumer price index increases; passing a constitutional amendment to require a balanced budget; limiting federal spending to a percentage of gross national product; and giving the President constitutional authority to veto line items in appropriation bills. Some 72 percent favored an immediate one-year freeze of fiscal 1985 spending at fiscal 1984 levels, an idea that has received much attention recently in Washington, D.C.

Respondents were emphatic in insisting that the federal deficit be lowered through cuts in government spending. Almost 88 percent agreed that tax increases must not be used by Congress to offset failures at implementing spending reductions.

Other Priorities

Government procurement. "Current government procurement practices result in the waste of billions of dollars annually and the denial of opportunity for millions of small businesses to participate in Federal procurements," a conference report charged. It went on to note that "numerous studies have consistently confirmed that increasing the share of procurements from small business will result in substantial savings to the Federal government." These savings are expected to result from increased competition and responsiveness to the special needs of smaller firms.

About 86 percent of respondents to the Price Waterhouse survey supported full and prompt payment for progress payments and for final payments on work satisfactorily completed. This includes direct federal contracts and contracts with prime contractors, who should provide the same payment terms in their subcontracts. The timely collection of receivables can, of course, be critical to a small firm's survival.

About 78 percent favored Congressional passage of amendments to the 1985 Defense Authorization Act and legislation addressing competition in spare parts procurement. Congress has responded to this sentiment. Recent enactment of the Small Business and Federal Procurement Competition Enhancement Act of 1984, as reported in the last issue of *Business Review*, promises to make it easier for smaller businesses to compete for federal government contracts. As noted, government contracting offers attractive and predictable profits, cost control benefits, research and development opportunities, and an enormous market—1983 federal contract awards totalled $168 billion.

Product liability. Citing inconsistent and conflicting state laws and court decisions, the conference reported that "businesses at all levels of the manufacturing, distribution and service chain are incurring high legal costs and unpredictable liability awards. The awards often penalize parties that were not actually responsible for any injuries incurred." Around 80 percent of survey respondents favored a national law that would define the obligations of manufacturers, distributors, and other parties in product liability for products they sell or service; and make only the party responsible for any injury from a product or service liable for that injury.

Additional Proposals

When ranked in order of overall approval, four additional proposals fall within the highest approval quartile:

- The Equal Access to Justice, Regulatory Flexibility and Paperwork Reduction Acts should be strongly enforced and specifically extended to include the IRS and Defense procurement system.
- In the area of tax simplification, it is necessary to legislate clear "safe harbor" guidelines for determining if a small business is at risk from the IRS asserting that debt is equity.
- Accord small business equal treatment in utility rate-base cases.
- Health care cost containment should be promoted by encouraging states to enact legislation requiring hospitals and health care providers to charge all patients on the same equitable basis and by forbidding the shifting of costs from one group to another.

Federal Technology Assistance

The Commerce Department's National Technical Information Service, meeting Congressional insistence that American business share in the benefits of federal research and development (R&D) programs, has taken steps to improve business access to particular areas of federal technology.

A *Directory of Federal Technology Resources* lists more than 800 federal sources of R&D expertise, laboratory facilities, specialized experience, and information in 30 technical areas, including medicine, physical and biological sciences, engineering, energy, earth resources, building and materials, and transportation. All listed resources were selected for unique capabilities not readily duplicated in the private sector. Participating agencies have indicated their willingness to share their unique expertise, equipment, and facilities. The directory identifies a personal contact for each facility.

A *Catalogue of Federal Patents* describes over 1,000 government inventions (arranged by 43 subject categories) available for licensing—many on an exclusive basis. Entrepreneurs have committed over $140 million to marketing inventions licensed through this program.

A *Federal Technology Catalogue* describes more than 1,000 new applications, processes, and equipment selected for commercial potential. The ten subject areas are computers, electrotechnology, energy, engineering, life sciences, machinery and tools, testing and instrumentation, manufacturing, materials, and physical sciences.

For more information, contact the National Technical Information Service, 5285 Port Royal Road, Springfield, VA 22161, (703) 487-4636.

Taxation of "Luxury" Automobiles And Other Business Property

If your business does or may soon own a "luxury" automobile or you make personal use of business property, you should be aware of certain provisions in the Deficit Reduction Act of 1984 ("Act"). The Act has limited the tax advantage for business use of automobiles costing more than $16,000. In addition, "listed property" (e.g., cars, boats, airplanes, personal computers, recreational property) used for business purposes for 50 percent or less of the time will not qualify for any investment tax credit (ITC) or accelerated depreciation.

Luxury Car Caps

ITC. For 1984, the maximum ITC allowable for each passenger auto placed in service after June 18 is $1,000. After 1984, this will be adjusted for inflation. If a taxpayer elects to reduce ITC in lieu of adjusting basis, the ITC is reduced to $667.

Recovery deductions. For autos placed in service after June 18, 1984, recovery deductions are limited to $4,000 per auto for 1984 and $6,000 per year thereafter. Future limits for autos placed in service in future years will also be adjusted for inflation. Any "unrecovered basis" of an auto after the normal recovery period may be deducted in succeeding years as long as the auto continues to be used for business purposes. "Unrecovered basis" is defined to mean that recovery deductions for future years cannot be based on recovery deductions disallowed in earlier years because of non-business/investment use in such earlier years. The recovery deductions allowed in succeeding years are also subject to the annual caps. Any amount disallowed as a deduction attributable to non-business/investment use remains in the unadjusted basis until disposition, and affects gain or loss at that time.

Listed Property Rules

Expensing election. A taxpayer may elect to expense a portion of the cost of listed property (autos, personal computers, etc.) under Internal Revenue Code Section 179 (limited to $5,000 through 1987). For purposes of the luxury car caps, this expense is treated as a recovery deduction.

General rule. Recapture of the ITC may be required and no accelerated recovery deductions will be allowed if qualified business use does not *exceed* 50 percent during the first three years for ITC purposes, and the first six (autos) or five (computers) years for cost recovery purposes.

ITC rules. No ITC is allowable for listed property if its "qualified business use" does not exceed 50 percent for the year placed in service. Qualified business use means any use in a trade or business, but not for production of income (investment use). Qualified business use includes use provided as compensation to other persons (e.g., personal use by an employee) if an amount equal to fair rental value is included in income and withheld upon. Similarly, employee personal use for which the employer is fairly reimbursed will be considered qualified business use by the employer. It does not include leasing to a 5 percent owner or use provided as compensation to a 5 percent owner. Increases in qualified business use after the first year neither affects the initial availability of the ITC nor increases the ITC. A reduction in qualified business use after the first year to 50 percent or less may trigger recapture of a portion of the ITC in the year of reduction.

Recovery deduction rules. Listed property items that are used no more than 50 percent for qualified business use must be recovered on a straight-line basis (over five years for autos; twelve years for computers). Also, the expense election under section 179 is not available if the more-than-50-percent test is not met in the initial year. After the qualified business use test is applied to calculate the proper recovery method, investment use is added to business use to determine the amount of the deduction. If the more-than-50-percent test is not met in a later year, recovery deductions for that year and subsequent years must be based upon the straight-line earnings-and-profits (E&P) life as if the property had originally been recovered on that method. Additionally, recovery deductions (including section 179 expense) allowable in prior years in excess of the amount that would have been allowable had the straight-line E&P method been utilized must be recaptured in the year that the more-than-50-percent test is not met. The recapture amount is added to the property's adjusted basis. No recapture is necessary in any year that the straight-line method produces a deduction as great or greater than the amount claimed.

Recordkeeping

Under new regulations, no deduction or credit will be allowed for any listed property unless it is substantiated by adequate contemporaneous records.

The adequate contemporaneous record requirement can be met only be keeping a log, diary, or similar record. A separate entry must be made for each use. The date, the name of user, the number of miles (for transportation property) or amount of time used (for other listed property—computers, etc.), and the purpose of the use must be specified for each use.

If the total use can be *definitely determined* for a taxable year, then only the business/investment use of the property must be documented. If the total use cannot be definitely determined, then entries are required for both personal and business/investment use. For example, the total use of an auto generally can be determined by comparing the beginning and ending odometer readings. Additional support for total use, such as repair or inspection records showing mileage, may be required, however. Total use of most computers generally cannot be determined without a log of all use.

The temporary regulations also provide that each entry must be made *at or near to* the time of use, without defining the term "near to".

Special Leased Property Rules

The ITC and recovery deduction limitations for listed property (including the luxury auto limitations for passenger automobiles) do not apply to persons regularly engaged in the business of leasing listed property.

Under new temporary regulations, the lessee deducts the full amount of auto lease payments to the extent they are allocable to business/investment use. For now, the regulations do not address the proper treatment of lump-sum front-end payments or nonrefundable deposits. The lessee must include an amount in gross income for *each taxable year*, prorated for the number of lease days included in the taxable year. This annual inclusion amount is determined by multiplying the year's business/investment use percentage by an amount taken from a table in the regulations. The annual inclusion requirement is intended to place a lessee in the same position, economically, as the owner of a "luxury auto" whose ITC and recovery deductions are limited by the luxury car caps.

When the qualified business use of listed property does not exceed 50 percent for any year, an *additional*, one-time amount is added to gross income for *that* year (and only that year). As with the annual inclusion amount, the one-time inclusion amount is calculated by reference to tables contained in the regulations.

Employee Deductions and ITC

Employee use of employee-owned listed property does not qualify as business/investment use for ITC, section 179 expensing, or recovery deduction purposes unless the use is for "the convenience of the employer" *and* is "required as a condition of employment". The use of the property must be required for the employee to perform his duties properly. However, the employer need not explicitly require the employee to use the property. Where the facts and circumstances indicate that the use of the property is a condition of employment, the use will be so considered and enter into the business/investment use. "Convenience of employer" is not defined, as yet, in the regulations.

It should be noted that non-business use by a 5 percent owner is not qualified business use for determining the availability of ITC and accelerated percentages. However, if personal use by a 5 percent owner is proven to be compensation (and not a dividend) and included on a W-2 and withheld upon, then this use will be included in business/investment use for the determination of the *amount* of ITC and recovery deductions.

If an automobile is used by an employee, that use will not count as use in a trade or business unless it is reported as income to the employee and withheld upon, *or* the employee pays a fair market rent. If an employee does pay fair market rent for the personal use element, then his personal use is considered to be both qualified business use and business/investment use by his employer. However, if he is also a 5-percent owner, reimbursed personal use only qualifies as business/investment use and does not count as qualified business use for purposes of determining eligibility for ITC or for use of accelerated recovery percentages.

Effective Dates

Except for the new recordkeeping rules, the new regulations generally only apply to listed property placed in service or leased after June 18, 1984. However, they do not apply to property acquired or leased pursuant to a binding contract in effect on June 18, 1984, and placed in service (or first used by the lessee) before 1985.

The new recordkeeping rules are effective for taxable years beginning after 1984. For example, a company with a June 30 year end will not be subject to these new requirements until its tax year beginning on July 1, 1985. The regulations specifically provide that the new recordkeeping requirements apply to all listed property for tax years beginning after 1984, *regardless* of when the property was placed in service. For example, a taxpayer would have to meet these new requirements for an automobile placed in service in 1983 if the taxpayer is to continue to claim cost recovery deductions in 1985.

Senator KERRY. Thank you very much. Just a couple of quick questions, if I can.

First of all, is there anything in that survey—and I appreciate your sharing the results with us—that surprised you? I mean, that leaped out at you?

Mr. BUCKLEY. Well, I think the areas concerning adding or training new employees—of the nearly 400 respondents, 30 percent of those respondents said that they was their No. 1 priority. And as was said, there really isn't anything in the tax reform proposal in the area of training of new employees. As Bob Haddad said, the payroll tax is one consideration.

Senator KERRY. One question you asked, I think it was something about what was the most important ingredient to you, and 30 percent responded——

Mr. BUCKLEY. Yes, 30 percent said it was R&D out of the entire total; 29 percent, said it was the tax credits for training of new employees, and another 29 percent said that it was capital investment in plant and equipment. We categorized those respondents by industry; when you took the respondents who indicated they were in the high-technology industries and their priority—45 percent of that category said R&D.

Senator KERRY. And the most significant proportion, obviously, said don't get rid of the ITC. Was that question posed to them simply, "Would you get rid of the ITC?" or was it posed to them—juxtaposed to the tradeoffs that would take place in an overall package? Does that make a difference?

Mr. BUCKLEY. It was posed to them separately, "Do you favor elimination"——

Senator KERRY. Will that answer change when it's in a package and there are tradeoffs?

Mr. BUCKLEY. Well, I think that these would be a very serious consideration of those respondents as to what the other changes or tradeoffs are in the reform

Senator KERRY. Now, Mr. Haddad, you mentioned the targeted jobs tax credit. I think you said that that's more important than the ITC, am I correct?

Mr. HADDAD. General jobs credit.

Senator KERRY. General jobs credit. Is it your experience—are people taking advantage of that?

Mr. HADDAD. Well, the targeted credit is really—because it is targeted, it is not nearly as advantageous as the general jobs credit was. The studies and surveys which were discussed at lenght in a couple of capital formation forums back in 1982 indicated that lack of awareness of the general jobs credit in 1977, 1976, or 1977, whenever it was, was one of the biggest reasons it wasn't taken advantage of.

So I think people would take advantage of it if they could. And the reason I made that statement was that the statistics show that small business is 75 percent labor-intensive and 25 percent capital-intensive. Arthur Anderson did a study on the Treasury I proposal, and they show that of $30 billion in increases that would result from the change in the depreciation rules, only 10 percent—I'm sorry, it was ITC, $30 billion of ITC that would be lost—only 10 percent would apply to small business. And so, if you compare it with whether or not—if you want to stimulate and you want to put capital with a business, then you ought to target it. The ITC was targeted when we were a capital-intensive manufacturing economy. We're a service-intensive, labor-intensive economy now, which is why I made that statement.

Senator KERRY. And I wonder if I could draw on you, beyond the SBANE role, to ask with respect to the accounting of inventories. Bradley-Gephardt, I believe, retains the current life of it, and I believe Treasury I and II got rid of it, or get rid of it, so the current proposal on the table is to get rid of that. Would you comment on what you think is the best treatment for inventories?

Mr. HADDAD. Well, the purpose LIFO is really one of matching revenues and expense so that you pay a tax on an income based on a real profit and not a contrived profit. LIFO—if you pay a dollar for something today and you sell it for $1.50, you ought to pay tax on 50 cents, and LIFO enables you to do that and not pay tax on a cost for something that you might have bought during an inflationary period for 80 cents and sold for $1.50.

So the theory makes sense. How you apply it—I mean, LIFO is an extremely complicated process to go through to calculate and maintain, and the conformation requirements under the current law are very difficult for small business. So whether they are in that form or some simplified form, and there is some indexing that's included in the current law, but the ability to use it is limited by the caps they've put on it—it's a very complicated process right now. I would encourage——

Senator KERRY. You would try to hold onto it?

Mr. HADDAD. Yes, in some form, and get rid of the conformity. One of the things that bothers small business, and that's true of the cash method of accounting proposal that's in the Reagan proposal and has been in other ones, is this conformity business. You can't prepare a financial statement and give it to the bank under these new rules and stay on the cash method unless you give the bank a cash method set of financials. They have the same thing for LIFO; that is ridiculous.

Senator KERRY. So the conformity requirement, per se, you would get rid of?

Mr. HADDAD. Yes, I would.

Senator KERRY. But maintain the concept?

Mr. HADDAD. Yes. The concept makes good sense.

Senator KERRY. All right.

Gentlemen, I wish we had more time; unfortunately we're running over, so I'm going to have to shift to the next panel. But what I would like to do is leave the record open so that we could, if we wanted to, submit further questions to you in writing and then compile the record.

I appreciate it very much. Thank you.

The next set—we have a momentary recess—let me just check here. Jim, a recess for 5 minutes, or what?

All right; we're going to take a recess for 5 minutes and we will reconvene 5 minutes from now.

[Short recess taken.]

Senator KERRY. I would ask each of the panelists if they could try to summarize to the greatest degree posssible. And as I say, your full testimony is going into the record and we will be following up on that, so it will not be lost by virtue of that curtailment.

The next panel is made up of Dr. Francis J. Berlandi from Touchstone Environmental Consulting, Inc.; Frank Carroll, whom many of you know in the small business world here in Massachusetts, from the Small Business Service bureau in Worcester; Ms. Alice Griffen from Griffen Pension Services, and Mr. Daniel Kaplan from Central Mass Media, Inc. And I think we'll begin with Dr. Berlandi.

STATEMENT OF DR. FRANCIS J. BERLANDI, TOUCHSTONE ENVIRONMENTAL CONSULTING, INC., WINCHESTER, MA

Dr. **Berlandi**. Thank you, Senator, for the opportunity to come before you. Also, I was invited by the Small Business Service Bureau, of which I am a member in the Worcester area.

What I've done, in order to prepare a statement for this hearing, is to call approximately 15 to 20 small business firms, individuals, and people that I've done business with in the past 5 to 10 years and to solicit some of their thoughts on small business and direct and indirect taxation. And so what I have is a synthesis, really of what these 15 random firms had to say.

I talked to the chief operating officers, and these firms included sales organizations, service organizations, manufacturing, software, laboratories, medical groups, real estate, and retail establishments. And when I originally started to speak with them, I thought we would have quite a bit of a breakdown into parochial interests with each of these groups. But I was quite surpirsed, in the original discussions with these individuals, that they all really shared some common thoughts on the taxation of the small business firm, both directly and indirectly.

And what one could liken it to—and I have five points that I'd like to make that would synthesize a lot of these discussions—was rather than go into detail and touch upon each particular item of a proposed tax reform, we liken it to an individual. The small business is an individual going into cardiac arrest. And to discuss—and you walk up to the individual and you say, on your way out the door to the afterlife, "Would you rather listen to Beethoven, Bach, or the Beatles?"

What we are saying is that there is something more inherently wrong with the direct and indirect taxation system in this country that a superficial reform is not going to touch.

Point No. 1, and we see this many times in the Wall Street Journal, responsible legislators making these statements, that corporations do not pay enough taxes. The fact is that the whole tax system in the United States is based upon the ability of the corporations to extract the payroll dollar before it hits the hands of the individual and to forward that money to Washington. If you look at the amount of money collected by the corporations, 30 to 40 cents goes directly to the Federal coffers. This is 15 percent of the payroll dollar for FICA and approximately 20 percent for withholding, which isn't that much. Five to ten cents goes into the States treasury, and on top of that we put the Federal unemployment tax, all collected and paid by the corporation. The recordkeeping, the administrative costs and all the associated files are kept by the company. Corporations are, in fact—they are de facto tax agents of the Federal Government and provide this country, by the way, with one of the finest, most efficient tax collection schemes yet devised.

What we'd like to have made known—and people know it, but it does not get into the press—that corporations are paying a 7.05 percent payroll tax designed to be increased to 7.65 percent by 1990. In 1982 alone, over $201 billion was collected under this type of taxation system.

The burden of the recordkeeping costs associated with not only forwarding the money to the appropriate Government agencies—they are putting an insurmountable burden on the small business organization. Every CEO contracted out of the 15 had a horror story regarding the paperwork mess and the fact that many of their forms are lost in the bureaucratic abyss.

OK, that's one part of the tax system that we really have to look at, that corporations are paying a lot of taxes, and we have some charts in the formal document here to show that for the first dollar that comes into the corporation that's destined, for, say, the employee's pocketbook, 45 cents goes directly out to the Government and 55 cents goes to the individual. And with that 55 cents, the individual then has the privilege of putting on his real estate taxes and he can put on his sales taxes and his gasoline taxes. So if you really look at the payroll dollar and the fraction of it that goes into—not even disposable income, but income for food, rent, and clothing—the individual does not have that amount of money. And I think it's important for the individuals to understand that, we really have to understand the economics of where the money comes from, generated through the corporation.

The other myth that we'd like to sort of set straight for the record is the attack on the Social Security System and the fact that anybody that is allowed to collect Social Security after the age of 65 and has any other means of income, that this individual should be considered a freeloader and all means necessary to discourage this type of behavior should be enacted by the Federal Government. What I did was, I did a small calculation, a very simple calculation. I took a $20,000 a year employee, and I took his Social Security money, 7.06 percent contributed by himself and the 7.06 percent contributed by the employers, and I put that aside every year and compounded it at 10 percent. Now, this is a $20,000 a year employee. The table and the mathematics show that at the end of 40 years, a working lifetime, 25 to 65 years, no inflation—the person makes a flat $20,000 for those 40 years—the amount of money compounded and accumulated in that fund is $1.44 million. Now, to allege that an individual who lives for 10 years, from age 65 to 75, and collects $10,000 a year of that money, collects $80,000 on the basis of having contributed a value equivalent to $1.44 million, is just beyond the logic that I'm capable of understanding.

Point No. 3, cost of tax simplifications, revisions, alternations, and increases are never taken into account in the indirect costs. What we see as happening is that in 1984 alone, the amount of pages involved in the Register regarding the congressional and the Senate tax bills were over 1,000 pages. One can have the privilege of subscribing to the BNA Daily Tax Report for the privilege of

$1,400 a year to get, on a daily basis, 20 pages of small print of tax changes that affect small businesses and the individual. You can subscribe to this service and you can read them as I've gone through and read them. I'm a chemist, and I've been reading this, and it's impossible for anybody to understand and stay up with the changes in the system.

Just as Congress requires agencies—EPA, OSHA, and any other agency—to evaluate the economic impact of any new legislation, we feel that the individual tax changes should be evaluated for their economic impact; and we wonder why that has been done, for example, with the car log. Even though that has been debated to death, if one assumes that an individual had to spend 10 minutes a day making the car log as a salesman, it turns out that the total cost to the company is over $2,000 a year for that individual to maintain the car log. That doesn't include the revisions that have to be made to the W-2 software, the payroll software, the 941 reporting—all required to keep track of this car mileage requirement.

The most the Government can hope to get out of that system is $100 to $500 per person; yet, the indirect burden on the corporation could be $2,500 to $3,000. We think that just from the economic comparison, that that type of recordkeeping log should have been killed before it even got out of Washington.

Point No. 4, another indirect, hidden cost of the tax system which is not addressed in any of the changes—but these individuals, 15 out of 15 of them, have had situations where they've tried to correct inaccurate recordkeeping procedures on the part of the Federal Government. This is where checks have been forwarded to the IRS, payments made, cancelled checks received back from the company. The rule of thumb—and this is three out of three accountants, three different accountants—the rule of thumb is, if you sent the check to the IRS and their computer says they don't have it, even if you have the canceled check and it's under $1,000, you would be better off sending them another check. Don't fight it; don't try to straighten it out.

What we'd like to see in the tax system, and many of these individuals, is to have the Senate and the congressional people visit the IRS offices unannounced and listen in on some of the complaints and the phone calls of the small business people trying to correct mistakes. The time and the effort, the time—time is money to the small businessman. If he has to spend 10 or 20 hours and have his part-time accountant—pay him by the hour to go in to correct any of these errors, it costs him literally thousands of dollars. Just as the phone company monitors the behavior of their operators by having a special line where they can tap in and listen to see whether the information operators are disseminating accurate information, we suggest that every IRS office have the same capability so that anybody in the congressional or Senate delegation can go in and listen to the type of complaints that are coming into the system, to show that it is unresponsive to correcting problems that they generate on their end. We think that is a major issue with the small businessman. He cannot afford to fight, even if he's right. It would be bad business to correct a $200 mistake and have it cost you $3,000 to do it. But we think that is what is fueling the statistics that the IRS issues on the number of tax cheats in the system, a tax cheat being defined as someone, when approached and asked, that you haven't paid enough, that they will produce the money and pay it. The question is, for those tax cheats, how many are smart enough to have paid not because they were wrong, but because it made good business sense to just pay the money and get out of the system and get them off your back?

Point No. 5, the tax changes and the deficit. The small business owners that we talked to were very concerned about the inordinate amount of debate that is going on regarding the specifics of the Tax Code changes. We don't see an equivalent amount of debate being placed on deficit reduction and control of the budget.

Yes, we see some debate on defense expenditures, which merely amounts to less than 25 percent of the Federal budget, but what about an equal amount of debate on the other 75 percent of the Federal budget?

As one CEO remarked, "If I used the Government's methods of management, I could increase my accounts receivable without increasing sales." [Laughter.]

When a small business with more than three employees is forced to file at the same frequency as General Motors on tax payment, on FICA and withholding—because the upper limit is $3,000; once you owe more than $3,000, you are on the three-day schedule—that's three employees. Above $3,000 up to $20 million, you're all in the same boat. We think that if that is what's happening, then indeed, the system is not sensitive to small business and this should be evaluated in any kind of tax reform. That 3-day payment rule—another hidden cost, another hidden tax which never shows up on the balance sheet.

I thank you.

[The prepared statement of Dr. Berlandi follows:]

STATEMENT OF DR. FRANCIS J. BERLANDI ON THE DIRECT AND INDIRECT TAX BURDEN ON THE SMALL BUSINESS CORPORATION

THE SUMMARY OF ISSUES IN THIS DOCUMENT REGARDING THE VIEWS OF SMALL BUSINESS ON TAXES HAS BEEN SUMMARIZED FROM INTERVIEWS WITH OVER FIFTEEN CEO'S FROM A BROAD RANGE OF CORPORATIONS. WHEN I ORIGINALLY STARTED, I FELT THAT THE DIVERSITY OF CORPORATE CHARACTER WOULD PRODUCE AN EVEN GREATER DIVERSITY OF CORPORATE COMMENT ON TAXES. HOWEVER, THE RESULTS DEMONSTRATE FAIRLY HOMOGENEOUS CONCERNS FROM ENDEAVORS COMPRISED OF

TECHNICAL PRODUCT SALES
TECHNICAL SERVICE ORGANIZATIONS
MANUFACTURING
LABORATORIES
SOFTWARE
MEDICAL GROUPS
REAL ESTATE
RETAIL ESTABLISHMENTS

THE INDIVIDUALS CONTACTED ARE NOT THOSE PRONE TO SPEAK OUT NOR ARE ANY OF THEM DESCRIBED AS POLITICAL ACTIVISTS OR PARASITES OF THE SYSTEM. EACH HAS ATTEMPTED TO CREATE A CORPORATE ENTITY TO PROVIDE GOODS OR SERVICES IN RETURN FOR A FAIR ECONOMIC REWARD FOR THEIR EFFORTS. ALL RESPONDEES HAVE BEEN IN BUSINESS FOR OVER 5-10 YEARS AND ARE STABLE, COMPETENT INDIVIDUALS. I WAS PROFUSELY THANKED BY EACH OF THOSE CONTACTED FOR MY EFFORT TO SPEAK IN THEIR BEHALF AND TO OBTAIN FIRST-HAND KNOWLEDGE OF THEIR CONCERNS. MANY EXPRESSED THEIR REGRET THAT THE TAX SYSTEM HAS DEGENERATED TO THE POINT WHERE THEY NOW FEEL THEIR MAJOR ROLE IS NOT TO RUN THEIR CORPORATIONS, BUT TO BE CONDUITS FOR TAX COLLECTION. ONE HIGHLY SUCCESSFUL CEO REMARKED THAT IF IT CAME DOWN TO DELIVERING A FEDERAL FICA CHECK TO THE BANK ON TIME OR ATTENDING A CRITICAL BUSINESS FUNCTION, HE WOULD OPT FOR MESSENGER STATUS AND DELIVER HIS CHECK. IT WOULD BE IMPOSSIBLE TO CONVEY THE COMPLETE IN-DEPTH CONCERNS EXPRESSED TO ME BY THESE INDIVIDUALS, BUT LET ME SAY THAT MANY WERE WEARY AND EXASPERATED AT THE NEVER-ENDING SUCCESSIONS OF "IMPROVEMENTS" IN THE TAX SYSTEM OVER THE PAST 6 TO 10 YEARS.

SEVERAL ASPECTS OF TAXES MUCH MORE SIGNIFICANT THAN A SUPERFICIAL TAX REFORM NEED TO BE ADDRESSED HERE:

#1: THE MYTH THAT CORPORATIONS PAY ONLY MINIMAL TAXES:

THE REALITY OF THE SITUATION IS THAT CORPORATIONS COLLECT, PROCESS, AND PAY ALMOST ALL THE TAXES COLLECTED BY THE FEDERAL GOVERNMENT TODAY. THE PAYROLL AND SOCIAL SECURITY TAXES ARE COLLECTED AND PAID WITH CORPORATION MONEY IN BEHALF OF EMPLOYEES WITHIN THEIR CORPORATIONS. FOR EVERY CORPORATE INCOME DOLLAR DESTINED FOR THE AVERAGE EMPLOYEE'S PAYCHECK, $.35-.40 GOES DIRECTLY TO THE FEDERAL COFFERS AND $.05-.10 GOES INTO THE STATE TREASURY. FIGURE 1. SHOWS A BREAKDOWN OF THE SALARY DOLLAR AS IT ENTERS THE CORPORATION. THE ADMINISTRATIVE COSTS OF HANDLING THIS MONEY ARE BORNE WITHIN THE CORPORATION AND ARE ESTIMATED AT ANOTHER $.05 PER DOLLAR. CORPORATIONS ARE THE DE-FACTO TAX AGENTS OF THE FEDERAL GOVERNMENT AND PROVIDE THIS COUNTRY WITH ONE OF THE FINEST, MOST EFFICIENT, TAX COLLECTION SCHEMES YET DEVISED.

LIBERTARIAN

WHY ARE THE CRITICS OF CORPORATE TAXES LOATHE TO MENTION THE 7.05% PAYROLL TAX THAT CORPORATIONS FORWARD FAITHFULLY TO THE GOVERNMENT COFFERS, WHICH WILL RISE TO 7.65% BY 1990. IN 1982 ALONE, OVER 201 BILLION DOLLARS CHANGED HANDS UNDER THE PAYMENTS FOR SOCIAL SECURITY PURPOSES. THE BURDEN OF RECORDKEEPING COSTS AND THE INCREASINGLY RIGID WEEKLY PAYMENT SCHEDULES ENDURED BY SMALL BUSINESSES ARE INSURMOUNTABLE. THE HORROR STORIES ARE ABUNDANT FOR MANY SMALL COMPANIES, WHO IN GOOD FAITH, MADE THESE PAYMENTS BUT WHOSE SUPPORTIVE PAPERWORK IS FOREVER LOST IN THE BUREAUCRATIC ABYSS.

Recent Myth! → #2: ANY WORKING PERSON FRUGAL ENOUGH TO SET ASIDE RETIREMENT MONEY AND COLLECT SOCIAL SECURITY IS A "FREELOADER" AND ADDITIONAL TAXES SHOULD BE COLLECTED TO DISCOURAGE SUCH BEHAVIOR:

IN TABLE I, A SINGLE CALCULATION HAS BEEN DONE TO DETERMINE THE AMOUNT OF MONEY DEPOSITED AS A SOCIAL SECURITY TAX FOR THE TYPICAL $20,000/YEAR EMPLOYEE BY BOTH THE INDIVIDUAL AND THE EMPLOYER. IF A LIFE EXPECTANCY OF 75 YEARS IS ASSUMED, AN INDIVIDUAL WILL COLLECT SOCIAL SECURITY FOR 10 YEARS AFTER AGE 65. THIS PERSON WOULD EXPECT TO RECEIVE APPROXIMATELY $80,000 IN BENEFITS OVER THIS 10-YEAR PERIOD. SINCE HIS TOTAL COMPOUNDED CONTRIBUTION IS OVER 1.4 MILLION DOLLARS, TO TAX THE $80,000 OR ANY FRACTION OF IT, IS A HIDEOUS FORM OF SOCIAL INJUSTICE, WHICH DEFIES RATIONAL EXPLANATION.

# 3: THE COST OF TAX SIMPLIFICATION/REVISION/ALTERATIONS/INCREASES/ETC.:

IN 1984, THE HOUSE AND SENATE APPROVED TAX-RAISING BILLS THAT RUN MORE THAN 1,000 PAGES EACH. THE CHANGES WERE SO COMPLEX

AND VOLUMINOUS MOST TAX PROFESSIONALS, INCLUDING THE IRS,WERE STYMIED BY THEM. IN THE WORDS OF ROSCOE EGGER, "ANY LONG-TERM ADVANTAGES OF CONGRESSIONAL REFORM ARE OFTEN OUTWEIGHED BY THE COMPLEXITIES ASSOCIATED WITH THE PASSAGE OF FREQUENT TAX BILLS." AS OF MAY 1984, 377 REGULATIONS WERE BACKLOGGED, SOME AS FAR BACK AS 1976.

JUST AS CONGRESS REQUIRES AN ECONOMIC IMPACT ANALYSIS FOR ANY AGENCY-PROMULGATED RULE-MAKING,THIS SAME CONDITION SHOULD HOLD FOR THEIR OWN REGULATIONS. IF THIS WERE THE SITUATION, HOW WOULD THE CURRENT CAR TAX LOG HAVE FARED UNDER SCRUTINY ? FOR EXAMPLE, THE AVERAGE CORPORATE CAR USER IN A SMALL COMPANY WOULD SPEND 10 MINUTES A DAY TO PREPARE AND CERTIFY THE LOG. THIS PRODUCES A COST OF $40/WEEK FOR RECORDS AND TRANSLATES TO OVER $2,000/YEAR. IN ADDITION, THE MODIFICATION OF PAYROLL RECORDS TO INCLUDE W-2, 941, AND OTHER UPDATES, WILL COST A MINIMUM ESTIMATED $250-$500 PER PERSON. THE INDIRECT COST TO THE COMPANY IS $2500, WHILE THE ANTICIPATED DIRECT GOVERNMENT REVENUE IS ON THE ORDER OF $100-$500 A YEAR PER PERSON.

THE OBJECTIONS TO ANY ONE FACET OF TAX CHANGE WOULD APPEAR MEAGER AND OF LIMITED STRENGTH. HOWEVER, THE TOTAL BURDEN ASSUMED BY THE SMALL CORPORATION FOR BOTH DIRECT AND INDIRECT TAXES CAN NEVER BE PROPERLY CALCULATED UNTIL THE LAWS ARE IN PLACE AND THE BURDEN EXPERIENCED.

#4: THE COST OF CORRECT TAX COLLECTION ERRORS:

IN 15 OF 15 COMPANIES POLLED, EACH ONE OF THEM HAD EXPERIENCED A SITUATION WHERE INCORRECT DATA ENTRY ON THE PART OF THE GOVERNMENT CLERKS HAD RESULTED IN A TAX CHALLENGE OF NON-PAYMENT. THE CEO'S HAD SPENT MUCH TIME AND EFFORT TO CORRECT THE PROBLEM, WHICH WAS SIGNIFICANT, EVEN WHEN COPIES OF CANCELLED CHECKS WERE PRODUCED. CURRENT INDEPENDENT ACCOUNTANT ADVICE TO SEVERAL OF THE FIRMS WAS THAT IF THE AMOUNT IN QUESTION IS UNDER $1,000, "WRITE A SECOND CHECK AND PAY DOUBLE TAXES." PERHAPS IT IS SITUATIONS LIKE THIS WHICH INFLATE THE IRS STATISTICS OF TAX CHEATS FOUND AND CORRECTED THROUGH SCREENING METHODS.

SEVERAL CEO'S SUGGEST THAT THE SENATOR VISIT THE LOCAL IRS OFFICE IN AN ANONYMOUS MANNER, AND LISTEN TO THE TYPICAL COMPLAINTS OF SMALL BUSINESSMEN AND OBSERVE FIRST-HAND THE INDIFFERENCE AND LACK OF SENSITIVITY WHICH THEY EXPERIENCE. AN UNSUBSTANTIATED STATISTIC OBTAINED INFORMALLY BY ONE SMALL BUSINESS OWNER FROM AN IRS EMPLOYEE, WAS THAT 50 COMPLAINTS A DAY FOR UNRECORDED, BUT CANCELLED WITHHOLDING & FICA CHECKS, ARE ROUTINELY RECEIVED ON THE IRS HOT-LINE.

#5: TAX CHANGES AND THE DEFICIT:

THE CURRENT OPINION IS THAT THERE HAS BEEN AN INORDINATE EMPHASIS PLACED ON TAX MODIFICATION AND MINIMAL DEBATE ON BUDGET REDUCTION. THE SMALL BUSINESS OWNER IS WELL AWARE OF THE DEFENSE BUDGET DEBATE; BUT, SINCE THE DEFENSE BUDGET IS ONLY 25% OF THE

TOTAL BUDGET FIGURE, WHY IS THERE NOT EQUAL EMPHASIS AND DEBATE ON NON-DEFENSE SPENDING?

AS ONE CEO REMARKED, IF I USED THE GOVERNMENT METHODS OF MANAGEMENT, I COULD "INCREASE MY ACCOUNTS RECEIVABLE WITHOUT INCREASING SALES."

IN SUMMARY, THE SMALL BUSINESS UNIT IS BEING BURDENED--NOT BY DIRECT TAXES, BUT BY A MORE INSIDIOUS FORM OF INDIRECT TAXATION. THE INDIRECT COSTS OF REPORTS, PAYMENT SCHEDULES, TIME CONSUMING CORRECTION PROCEDURES, AND THE GUILTY-UNTIL-PROVEN-INNOCENT SYNDROME FOR TAX COLLECTION PURPOSES SAPS THE STRENGTH AND CREATIVE SKILLS OF MOST CORPORATIONS. IF THE SMALL BUSINESS IS TO SURVIVE AND FLOURISH, AND TO CONTINUE TO PROVIDE STABLE JOBS AND SERVICES, THE GOVERNMENT MUST ACKNOWLEDGE AND REDUCE THE UNREASONABLE DEMANDS IT NOW INSISTS UPON.

WHEN A SMALL BUSINESS FIRM WITH MORE THAN 3 EMPLOYEES IS REQUIRED TO FILE PAYMENTS WITH THE SAME FREQUENCY AS GENERAL MOTORS, THEN SOMETHING IS DEFINITELY WRONG.

CORPORATE PAYROLL DOLLAR

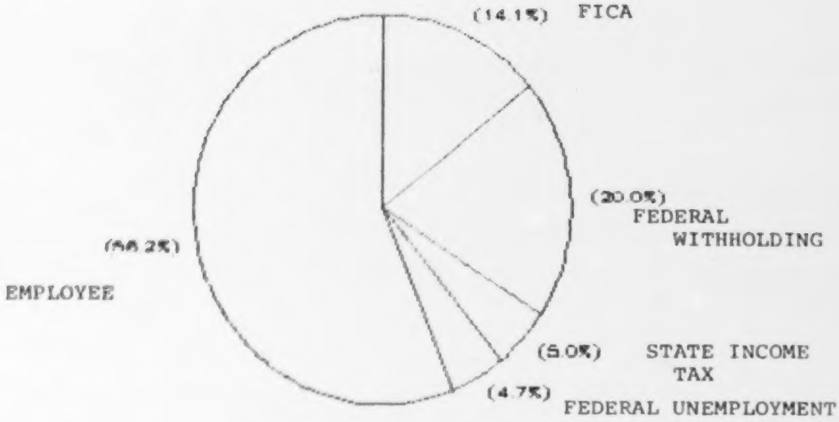

FIGURE 1.

CORPORATE PAYROLL DOLLAR

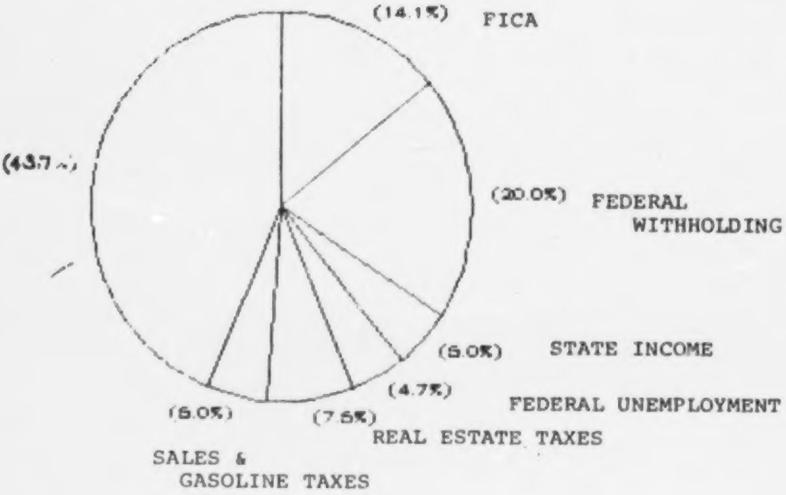

FIGURE 2.

TABLE I

ACCUMULATED FICA FUNDS

YEARLY SALARY*	VALUE AT 20 YEARS (AGE 45)**	VALUE AT 40 YEARS (AGE 65)**
$20,000	$186,054.98	$1,444,472.54
$40,000	$372,109.96	$2,888,945.08

*FLAT SALARY, NO RAISES OR INFLATION ADJUSTMENT

**VALUE BASED ON 10% AVERAGE YEARLY RETURN

Senator KERRY. Thank you. We're glad you abbreviated that one. [Laughter.]

No, I appreciate it. That was excellent testimony, and I'm very, very appreciative; it was genuinely frank.

STATEMENT OF FRANK CARROLL, PRESIDENT, SMALL BUSINESS SERVICE BUREAU, WORCESTER, MA

Mr. CARROLL. As you know, John, I am president of Small Business Service Bureau, which is a national for-profit organization of 35,000 small businesses across the United States, and 8,000 members in the State of Massachusetts. Again, we have two members here today, Dan Kaplan and Dr. Berlandi, and I want to commend you for focusing your first hearing on the administration's tax reform proposal, a topic of—as we know—great importance to small business.

We support much of the President's plan to simplify taxes. It is a significant improvement over the Treasury Department's previous proposals.

The President's plan—I think this is important—will result in lower taxes for the several million sole proprietors in this country. And 61 percent of SBSB's members pay personal income taxes for their Federal business taxes, and I think that's important. The reduced personal tax rates will clearly benefit them.

The graduated corporate tax rates are also much fairer to small firms than the Treasury's proposed 33 percent flat rate. Under the Treasury's proposed 33 percent flat rate. Under the Treasury proposal, businesses with earnings under $100,000 would have seen their taxes double, while high-income businesses would have enjoyed a 30-percent tax cut.

Despite these positive cuts, certain aspects of the administration's plan could be adjusted to be of greater benefit to the Nation's 7.2 million small businesses. And I'm glad to hear that the accountants this morning brought up the taxing of health insurance, because to many small business people, self-employed individuals, that's critical. The provision to tax employer-paid health, which unfortunately remains part of the President's tax plan, would impose an unfair burden on small business. As one of the biggest fringe benefits employers offer their workers, this tax on health insurance premiums will hit small firms much harder than their big competitors. While the President proposes only a small tax now, it sets a very bad precedent. Over the long term, this tax will actually cost the Nation money as people are forced into low-quality health care and coverage. Once a health care tax is on the books, it will go up and up. I think in terms of quality health care for the Nation, it is critical, and I think that good-quality health care will suffer with that kind of a tax.

I would also like to have you, Senator, remind President Reagan of his promise to enact no new taxes. We think this is a back door approach, similar to what you said in the beginning.

Small businesses need tax relief, not another regressive tax. We would suggest that the administration and Congress take a good look at Senator Kasten's bill, S. 1085, the Small Business Investment Act of 1985. I won't go into that in the interests of brevity, but this bill features a provision allowing unincorporated small businesses to deduct fringe benefits. It's unfair that an unincorporated small business owner is denied this deduction which is granted to big competitors.

And skipping through my testimony, the President's provision for capital gains, which lowers the tax rate from 20 percent to 17.5 percent, is a big improvement over earlier proposals. The last time the tax rate was reduced under ERTA, millions of dollars were shifted from tax shelters to income-producing enterprises, spurring investment and stimulating the economy which, of course, we heard this morning.

More than 75 percent of our members are opposed to the repeal of the investment tax credit. But an issue of even greater concern to them is, can they afford to invest in machinery and equipment to begin with? Do they have the money? And having cash available is more important than a deduction. As one of our members stated, "The ITC on machinery is not an incentive because it's nothing for nothing." They don't have any money.

Small businesses should be allowed to expense small purchases in the current tax year because it is difficult to project tax liability 10 to 20 years in the future, as would be true under the capital cost recovery system. This is another example of how the current system is geared to the large, established manufacturer and not the growth-oriented small business.

Finally, I would like to address the proposed cap on business meal deductions. While the President's provision is more favorable to small business than previous proposals, in my opinion political expediency has led to an attack on this legitimate business expense. Business meals are an important business tool, not a frivolous perk. The "three martini lunch" is really a Perrier lunch. You know as well as I that the small business owner does not have the time or the money to waste on liquid lunches.

Taxing business meals will particularly hurt restaurants and sales representatives who rely on the business lunch to conduct their business. For the travel agent, for example, who must compete in a low-commission, competitive environment, it is a necessary cost of doing business in order to compete with a large tour operator for the same accounts. This is also true for the small retailer who is trying to convince the distributor to allow him to carry his line. Many people don't realize this, but small retailers, because they don't enjoy large volume—the large distributors won't even sell to them. Now, that's a case of discrimination that I'd love to see tested one of these days, but the small retailer has to really lobby this large distributor to sell to him or to her. And that's primarily because of this small volume. The majority of people who use this deduction are hard-working business people who should not be penalized for the dishonest actions of a few.

The public should be outraged that when business lunch deductions are under attack, the use of limousines and corporate jets is still protected as legitimate, deductible business expenses for corporate executives in President Reagan's tax plan. We think that's absolutely a case of unfair taxation.

As Congress dickers over the specifics of tax reform, we lose sight of the larger questions. Of course, we talked about the deficit;

in the interests of time, I'll just quote Senator Paul Tsongas as he has often said before the Senate and the Democratic National Committee, "Our focus should be on creating wealth and income, not just redistributing and spending it."

[The prepared statement of Mr. Carroll follows:]

Small Business
Service Bureau Inc.
TM
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Worcester, MA 01601 • (617)756-3513

TESTIMONY OF FRANCIS R. CARROLL

PRESIDENT

SMALL BUSINESS SERVICE BUREAU, INC.

BEFORE THE

UNITED STATES SENATE SMALL BUSINESS COMMITTEE FIELD HEARING

BOSTON, MASSACHUSETTS

JULY 3, 1985

REGARDING

TAX-REFORM

SENATOR KERRY, I WANT TO THANK YOU FOR THIS OPPORTUNITY TO APPEAR BEFORE THIS SENATE SMALL BUSINESS COMMITTEE FIELD HEARING TODAY TO PRESENT THE IDEAS OF THE SMALL BUSINESS SERVICE BUREAU, INC. AND ITS MEMBERS.

MASSACHUSETTS HAS A STRONG SMALL BUSINESS COMMUNITY THAT NEEDS YOU TO CONTINUE ITS REPRESENTATION IN WASHINGTON. I AM FRANK CARROLL, PRESIDENT OF THE SMALL BUSINESS SERVICE BUREAU, A NATIONAL ORGANIZATION WITH 35,000 MEMBERS ACROSS THE COUNTRY, AND 8,000 MEMBER FIRMS HERE IN MASSACHUSETTS. TWO OF OUR MEMBERS ARE HERE TODAY TO TESTIFY; DANIEL J. KAPLAN, PUBLISHER OF CENTRAL MASS MEDIA, INC. BASED IN WORCESTER, AND DR. FRANCIS J. BERLANDI, PRESIDENT OF TOUCHSTONE ENVIRONMENTAL CONSULTANTS, INC. OF WINCHESTER.

I COMMEND YOU SENATOR, FOR FOCUSING YOUR FIRST FIELD HEARING ON THE ADMINISTRATION'S TAX REFORM PROPOSAL; A TOPIC OF GREAT IMPORTANCE TO SMALL BUSINESS.

WE SUPPORT MUCH OF THE PRESIDENT'S PLAN TO SIMPLIFY TAXES; IT IS A SIGNIFICANT IMPROVEMENT OVER THE TREASURY DEPARTMENT'S PREVIOUS PROPOSALS.

THE PRESIDENT'S PLAN WILL RESULT IN LOWER TAXES FOR THE 10 MILLION SOLE PROPRIETORS IN THIS COUNTRY. SIXTY-ONE PERCENT OF SBSB'S MEMBERS PAY PERSONAL INCOME TAXES FOR THEIR FEDERAL BUSINESS TAXES. THE REDUCED PERSONAL TAX RATES WILL CLEARLY BENEFIT THEM.

THE **GRADUATED CORPORATE TAX RATES** ARE ALSO MUCH FAIRER TO SMALL FIRMS THAN THE TREASURY'S PROPOSED 33 PERCENT FLAT RATE. UNDER THE TREASURY PROPOSAL, BUSINESSES WITH EARNINGS UNDER $100,000 WOULD HAVE SEEN THEIR TAXES DOUBLE, WHILE HIGH-INCOME BUSINESSES WOULD HAVE ENJOYED A 30 PERCENT TAX CUT.

DESPITE THESE POSITIVE CUTS, CERTAIN ASPECTS OF THE ADMINISTRATION'S PLAN COULD BE ADJUSTED TO BE OF GREATER BENEFIT TO THE NATION'S 7.2 MILLION SMALL BUSINESSES.

THE PROVISION TO **TAX EMPLOYER-PAID HEALTH INSURANCE**, WHICH UNFORTUNATELY REMAINS PART OF THE REAGAN TAX PLAN, WOULD IMPOSE AN UNFAIR BURDEN ON SMALL BUSINESS. AS ONE OF THE BIGGEST FRINGE BENEFITS EMPLOYERS OFFER THEIR WORKERS, THIS TAX ON HEALTH INSURANCE PREMIUMS WILL HIT SMALL FIRMS MUCH HARDER THAN THEIR BIG COMPETITORS. WHILE THE PRESIDENT PROPOSES ONLY A SMALL TAX NOW, IT SETS A VERY BAD PRECEDENT. OVER THE LONG TERM, THIS TAX WILL ACTUALLY COST THE NATION MONEY AS PEOPLE ARE FORCED INTO LOW QUALITY HEALTH CARE AND COVERAGE. ONCE A HEALTH CARE TAX IS ON THE BOOKS, IT WILL GO UP AND UP. WITH APOLOGIES TO WILL ROGERS; "I NEVER MET A TAX THAT DIDN'T HIKE." I WOULD ALSO REMIND THE PRESIDENT OF HIS PROMISE TO ENACT "NO NEW TAXES."

SMALL BUSINESSES NEED TAX RELIEF, NOT ANOTHER REGRESSIVE TAX. WE WOULD SUGGEST THAT THE ADMINISTRATION AND CONGRESS TAKE A GOOD LOOK AT **SENATOR KASTEN'S BILL, S. 1085**: THE SMALL BUSINESS INVESTMENT ACT OF 1985.

THIS BILL FEATURES A PROVISION ALLOWING UNINCORPORATED SMALL BUSINESSES TO DEDUCT FRINGE BENEFITS. IT IS UNFAIR THAT AN UNINCORPORATED SMALL BUSINESS OWNER IS DENIED THIS DEDUCTION WHICH IS GRANTED TO HIS BIG COMPETITORS. IT WOULD ALSO ALLOW A SELF-EMPLOYED SMALL BUSINESS OWNER TO DEDUCT HALF HIS SOCIAL SECURITY CONTRIBUTION AND WOULD ENSURE THAT AN OWNER/EMPLOYEE OF A SMALL BUSINESS IS ELIGIBLE TO RECEIVE FULL BENEFITS OF UNEMPLOYMENT COMPENSATION. CURRENTLY, SMALL BUSINESS OWNERS MUST PAY FUTA TAXES BUT CANNOT COLLECT BENEFITS. → Walter Floss

INTEGRATING THESE FEATURES INTO A TAX REFORM PACKAGE WOULD PROVIDE THE BOOST THE SMALL BUSINESS SECTOR NEEDS TO HELP KEEP THE ECONOMY HEALTHY. ACCORDING TO A RECENT SURVEY CONDUCTED BY DUN & BRADSTREET, HIRING INTENTIONS ARE STRONGEST AMONG SMALL BUSINESSES. FIFTY-THREE PERCENT OF NEW JOB OPENINGS THIS YEAR WILL COME FROM FIRMS WITH LESS THAN 100 EMPLOYEES. ANY TAX REFORM PACKAGE SHOULD ACKNOWLEDGE THE IMPORTANCE OF THE SMALL BUSINESS SECTOR IN OUR ECONOMY.

THE PRESIDENT'S PROVISION FOR **CAPITAL GAINS**, WHICH LOWERS THE TOP RATE FROM 20 TO 17.5 PERCENT, IS A BIG IMPROVEMENT OVER EARLIER PROPOSALS. THE LAST TIME THE TAX RATE WAS REDUCED UNDER ERTA, MILLIONS OF DOLLARS WERE SHIFTED FROM TAX SHELTERS TO INCOME-PRODUCING ENTERPRISES, SPURRING INVESTMENT AND STIMULATING THE ECONOMY. WE ARE DISAPPOINTED HOWEVER, THAT THERE IS NO SPECIFIC PROVISION IN THE PRESIDENT'S PLAN TO HELP START-UP AND NEW BUSINESSES TO ENCOURAGE INNOVATION OR INVESTMENT.

MORE THAN 75 PERCENT OF OUR MEMBERS ARE OPPOSED TO THE **REPEAL OF THE INVESTMENT TAX CREDIT.** BUT AN ISSUE OF EVEN GREATER CONCERN TO THEM IS CAN THEY AFFORD TO INVEST IN MACHINERY AND EQUIPMENT TO BEGIN WITH? HAVING THE CASH AVAILABLE IS MORE IMPORTANT THAN THE DEDUCTION. AS ONE OF OUR MEMBERS STATED: "THE ITC ON MACHINERY IS NOT AN INCENTIVE; BECAUSE NOTHING FROM NOTHING IS NOTHING."

SMALL BUSINESSES SHOULD BE ALLOWED TO **EXPENSE SMALL PURCHASES** IN THEIR CURRENT TAX YEAR BECAUSE IT IS DIFFICULT TO PROJECT TAX LIABILITY 10 TO 20 YEARS INTO THE FUTURE, AS WOULD BE TRUE UNDER THE CAPITAL COST RECOVERY SYSTEM. THIS IS ANOTHER EXAMPLE OF HOW THE CURRENT SYSTEM IS GEARED TO THE LARGE ESTABLISHED MANUFACTURER AND NOT THE GROWTH-ORIENTED SMALL BUSINESS.

FINALLY SENATOR, I WOULD LIKE TO ADDRESS THE PROPOSED **CAP ON BUSINESS MEAL DEDUCTIONS.** WHILE THE PRESIDENT'S PROVISION IS MORE FAVORABLE TO SMALL BUSINESSES THAN PREVIOUS PROPOSALS, THE MEASURE IS AN OFFERING AT THE ALTAR OF PUBLIC OPINION. PUBLIC PRESSURE HAS LED TO A PROPOSED TAX ON THIS LEGITIMATE BUSINESS EXPENSE. BUSINESS MEALS ARE AN IMPORTANT BUSINESS TOOL, NOT A FRIVOLOUS PERK. THE "THREE MARTINI LUNCH" IS REALLY A PERRIER LUNCH. YOU KNOW AS WELL AS I, THAT THE SMALL BUSINESS OWNER DOESN'T HAVE THE TIME OR MONEY TO WASTE ON LIQUID LUNCHES.

TAXING BUSINESS MEALS WILL PARTICULARLY HURT RESTAURANTS AND SALES REPRESENTATIVES WHO RELY ON THE BUSINESS LUNCH TO CONDUCT THEIR BUSINESS. FOR THE TRAVEL AGENT WHO MUST COMPETE IN A LOW COMMISSION, COMPETITIVE ENVIRONMENT, ITS A NECESSARY COST OF DOING BUSINESS IN ORDER TO COMPETE WITH LARGE TOUR OPERATORS FOR THE SAME ACCOUNTS. THIS IS ALSO TRUE FOR THE SMALL RETAILER WHO IS TRYING TO CONVINCE THE DISTRIBUTOR TO ALLOW HIM TO CARRY HIS LINE, DESPITE A SMALL VOLUME. THE MAJORITY OF PEOPLE WHO USE THIS DEDUCTION ARE HARD-WORKING BUSINESS PEOPLE WHO SHOULD NOT BE PENALIZED FOR THE DISHONEST ACTIONS OF A FEW.

THE PUBLIC SHOULD BE OUTRAGED THAT THE USE OF LIMOUSINES AND CORPORATE JETS IS STILL PROTECTED AS A LEGITIMATE DEDUCTIBLE BUSINESS EXPENSE FOR CORPORATE EXECUTIVES IN THE REAGAN TAX PLAN.

AS CONGRESS DICKERS OVER THE SPECIFICS OF TAX REFORM, WE MUST NOT LOSE SIGHT OF THE LARGER QUESTIONS.

1. CAN THE CONGRESSIONAL LEADERSHIP COME TO GRIP WITH THE EXCESSIVE LEVEL OF GOVERNMENT SPENDING THAT IS NOW AT A HISTORIC HIGH OF 25% OF GNP. THAT LEVEL IS TOO HIGH FOR EVEN THE STRONGEST OF ECONOMIES TO SUPPORT.

I FEAR THAT THE DEFICIT ITSELF IS SUCH AN ENORMOUS PROBLEM THAT IT WILL IMPEDE THE ABILITY OF CONGRESS TO FOCUS ON TAX REFORM UNLESS AND UNTIL A CRISIS SITUATION FORCES A TAX INCREASE.

2. WILL THE ECONOMY BE STRONGER AFTER TAX REFORM HAS BEEN PUT IN PLACE OR WILL THE THREAT OF TAX REFORM IMMOBILIZE INVESTORS WHO WOULD BE SPURRING LOCAL ECONOMIES? WE MUST BE ABLE TO CREATE A TAX CODE WHERE THE INCENTIVE IS TO MAKE YOUR BUSINESS GROW, NOT JUST TO PAY LESS TAXES.

AS PAUL TSONGAS SAID OFTEN IN THE SENATE, OUR FOCUS SHOULD BE ON CREATING WEALTH AND INCOME NOT JUST REDISTRIBUTING AND SPENDING IT.

Senator **Kerry**. Thank you very much.

Ms. Griffin.

STATEMENT OF ALICE B. GRIFFIN, CHIEF EXECUTIVE OFFICER, GRIFFIN PENSION SERVICES, SOUTH HAMILTON, MA

Ms. **Griffin**. Good morning. My name is Alice Griffin; I am the owner and chief executive officer of Griffin Pension Services, Inc., located in Hamilton, MA. My business affiliations include serving as a director of the Smaller Business Association of New England, the New England Women's Business Council, and the Northshore Chamber of Commerce. I presently serve as chairman of the board of that regional chamber. I base my opinions of the proposed tax reforms on my experience in managing our company and our day-to-day efforts to provide design and administrative services to more than 380 small businesses maintaining qualified retirement programs. This morning, I will comment on tax reform in general as a business owner, and I will also comment on the specific proposals for tax reform as they relate to qualified retirement programs.

Our business was established in 1979. It has grown from 1 employee to 10, thus proving the small business claim to job formation. We have taken advantage of the current tax law, utilizing the provisions of investment tax credit, accelerated depreciation, and low corporate tax rates. These combined techniques, along with a lot of hard work, have kept us alive and enabled us to grow. Yes, we are willing to relinquish some of our current tax advantages because we are now on our feet, but I worry about other small firms who are just beginning the long process of becoming established businesses and how they can succeed without these considerations. The truth is, they cannot, and tax reform has to provide the measures to assist new firms.

We think we are a good example of what can happen if the proper incentives are available. I repeat, we are now 10 employees, and the tax revenue that each employee is personally contributing to the system has to have justified the cost of the incentives to the business.

While payroll taxes are not the subject of current tax reform proposals, it is impossible for me to separate payroll taxes from corporate taxes. That expense is cutting deeply into corporate profits. The payroll tax squeeze on small businesses has us hurting before we even reach the point of calculating corporate tax on annual profits. It is unfair to examine the assessment of tax burden without examining the portion of payroll taxes that are paid by the labor-intensive small business.

Each of the currently debated tax reform proposals carries provisions to once again alter the sections of the Tax Code which pertains to the private pension system. Current law provides tax-favored treatment with respect to a variety of employer-sponsored and individual retirement plans. I would like to express our concern on behalf of small business on matters of qualified retirement programs.

There is no question but that there are inequities in the public and private system for accumulating retirement income. Small businesses were discriminated against by introducing top-heavy rules in the pension changes that were included in the 1982 TEFRA legislation. These inequities should be addressed by first establishing a national retirement income policy and allowing tax law and tax reform to speak to such a policy.

Pension and other retirement plans focus on the long-term income needs of our population. For more than 10 years, Congress has modified the Tax Code as it pertains to private employer and personal retirement savings programs. These annual modifications which have been instituted through law are expensive and weaken the ultimate goals of the retirement plans. Any new tax reform program should preserve and enhance the private pension system. The inherent long-term nature of the private pension system requires an environment of stability in order to thrive. The constant tinkering with the rules in recent years not only causes termination of plans, but discourages the formation of new programs.

Our clients are not experiencing the costly changes imposed by TEFRA. Delays by the Treasury in issuing approval letters on prototype documents has further complicated the process. Two further changes in the law have crippled the governmental agencies in accommodating these changes. Now we see more substantive changes being proposed in tax reform. This can only add more disruption and it is the small firms that pay the greatest price.

I urge this committee to request a temporary moratorium on changes in tax law relating to qualified corporate and individual retirement accumulation programs. No one knows the long-term impact of this constant flow of change and mounting paperwork, to say nothing of change in software programs to track the results. This change is tampering with a program that is vital to the livelihood of our citizens in their retirement years.

The importance of the private pension system to today's people is reflected in the fact that there are nearly 800,000 private retirement plans in America, and 59 percent of all nonagricultural wage and salary workers are covered. The total retirement plans' assets currently exceed $1 trillion. Private pension funds are the largest single institutional investor in the American economy.

Studies indicate that by the year 2007, over 71 percent of all families at retirement age will receive a private pension, and that average annual benefit will be $9,300, which will exceed the average Social Security pension they will receive. These private pensions are directed toward the lower income Americans rather than the economic elite. Some 71 percent of the total ERISA work force is covered by private pensions. Of that work force, 76 percent of its members earn up to $25,000 per year; 21 percent earn between $25,000 and $50,000 per year, and 3 percent earn over $50,000 per year. By comparison, 72 percent of those covered by pensions are in the under-$25,000 pay category. Only 4 percent of pension-covered employees earn over $50,000.

It is within the small- to mid-size businesses where the lack of pension coverage is most prevalent. These employers need incentives to establish qualified retirement programs. They have observed the trend in tax law to withdraw incentives for the employer establishing such a plan. They have observed the growing burden of compliance as tax laws require constant revisions to their plans, and they have observed the legislative discrimination which has been applied to the small business sector when enacting changes in retirement plan tax legislation.

I urge this committee to closely examine the reform measures relating to retirement income accumulation. If they must change, there should be no distinction between the small and larger employer as regards to benefit limits, tax treatment upon distribution, or contribution limits. Incentives should be provided which foster the private pension system as it provides meaningful retirement benefits to millions of Americans.

It is my opinion that both the Department of Treasury and Congress have allowed a few cases of extreme abuse to influence their thinking and blur their vision as to the needs for a sound private pension system. The private pension system has been viewed as an expensive tax expenditure. Contrary to popular belief, there is not a dollar-for-dollar loss to the Treasury for current deductions and exclusions; studies have indicated that after adjustment for interest and inflation, the Government will eventually collect between 64 percent and 72 percent of the taxes initially deferred.

A private pension system is a vital component in providing lifetime retirement income for Americans. Stability must be restored to that private pension system. The burden of constant change in tax law is most severe on the small employer, and threatens the retirement livelihood of many Americans.

Thank you.

[The prepared statement of Ms. Griffin follows:]

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TESTIMONY OF
ALICE B. GRIFFIN, PRESIDENT

GRIFFIN PENSION SERVICES, INC.

TO THE

SENATE SMALL BUSINESS COMMITTEE
FIELD HEARING ON TAX REFORM

BOSTON, MA

JULY 3, 1985

Good morning, my name is Alice Griffin. I am the owner and Chief Executive Officer of Griffin Pension Services, Inc. located in Hamilton, MA. My business affiliations include serving as a Director of the Smaller Business Association of New England, the New England Women's Business Counsel and the Northshore Chamber of Commerce. I presently serve as Chairman of the Board of that regional Chamber. I base my opinions of the proposed tax reforms on my experience in managing our company and our day-to-day efforts to provide design and administrative services to more than 380 small businesses maintaining Qualified Retirement Programs. This morning I will comment on tax reform in general as a business owner, and I will also comment on the specific proposals for tax reform as they relate to Qualified Retirement Programs.

Our business was established in 1979. It has grown from one employee to ten, thus proving the Small Business claim to job formation. We have taken advantage of current tax law, utilizing the provisions of Investment Tax Credit, Accelerated Depreciation and Low Corporate Tax Rates. These combined techniques along with a lot of hard work have kept us alive and enabled us to grow. Yes, we are willing to relinquish some of our current tax advantages because we are now on our feet, but I worry about other small firms who are just beginning the long process of becoming established businesses, and how they can succeed without these considerations. The truth is they cannot, and tax reform has to provide the measures to assist new firms.

We think we are a good example of what can happen if the proper incentives are available. I repeat, we are now ten employees and the tax revenue that each employee is personally contributing to the system has to have justified the cost of the incentives to the business.

While payroll taxes are not the subject of current Tax Reform Proposals, it is impossible for me to separate payroll taxes from corporate taxes. That expense is cutting deeply into Corporate profits. The payroll tax squeeze on small businesses has us hurting before we even reach the point of calculating corporate tax on annual profits. It is unfair to examine the assessment of tax burden without examining the portion of payroll taxes that are paid by the labor intensive small business.

Each of the currently debated tax reform proposals carry provisions to once again alter the sections of the tax code which pertain to the Private Pension System. Current law provides tax favored treatment with respect to a variety of employer sponsored and individual retirement plans. I would like to express our concerns on behalf of Small Business on matters of Qualified Retirement Plans.

There is no question but that there are inequities in the public and private system for accumulating Retirement Income. Small businesses were discriminated against by introducing Top Heavy Rules in the Pension changes that were included in the 1982 TEFRA Legislation. These inequities should be addressed by first establishing a National Retirement Income Policy and allowing tax law and tax reform to speak to such a policy.

Pension and other Retirement Plans focus on the long term income needs of our population. For more than 10 years Congress has modified the Tax Code as it pertains to private employer and personal retirement savings programs. These annual modifications which have been instituted through law are expensive and weaken the ultimate goals of the retirement plans. Any new Tax Reform Program should preserve and enhance the Private Pension System. The inherent long term nature of the Private Pension System requires an environment of stability in order to thrive. The constant tinkering with the rules in recent years, not only causes termination of Plans but discourages the formation of new Programs.

Our clients are now experiencing the costly changes imposed by TEFRA. Delays by the Treasury in issuing approval letters on prototype documents has further complicated the process. Two further changes in the law have crippled the governmental agencies in accomodating these changes. Now we see more substantive changes being proposed in tax reform. This can only add more disruption and it is the small firms that pay the greatest price.

I urge this committee to request a temporary moratorium on changes in tax law relating to Qualified Corporate and Individual Retirement Accumulation programs. No one knows the long term impact of this constant flow of change and mounting paperwork to say nothing of change in software programs to track the results. This change is tampering with a program that is vital to the livelihood of our citizens in their retirement years.

The importance of the Private Pension System to today's people is reflected in the fact that there are nearly 800,000 Private Retirement Plans in America and 59% of all nonagricultural wage and salary workers are covered. The total Retirement Plans' assets currently exceed one trillion dollars. Private Pension Funds are the largest single institutional investor in the American economy.

Studies indicate that by the year 2007 over 71% of all families at Retirement age will receive a Private Pension and that average annual benefit will be $9,300 which will exceed the average Social Security Pension they will receive. These Private Pensions are directed toward the lower income Americans rather than the economic elite. 71% of the total ERISA work force is covered by a Private Pension. Of that work force, 76% of its members earn up to $25,000 per year, 21% earn between $25,000 and $50,000 per year and 3% earn over $50,000 per year. By comparison, 72% of those covered by Pensions are in the under $25,000 pay category. Only 4% of Pension covered employees earn over $50,000.

It is within the small to mid-sized businesses where the lack of Pension coverage is most prevalent. These employers need incentives to establish Qualified Retirement Plans. They have observed the trend in Tax Law to withdraw incentives for the employer establishing such a Plan. They have observed the growing burden of compliance as Tax Laws require constant revisions to their Plans and they have observed the legislative discrimination which has been applied to the Small Business Sector when enacting changes in Retirement Plan Tax Legislation.

I urge this Committee to closely examine the reform measures relating to Retirement Income Accumulation. If they must change there should be no distinction between the small and larger employer as regards to Benefit Limits, Tax Treatment upon distribution or Contribution limits. Incentives should be provided which foster the Private Pension System as it provides meaningful Retirement benefits to millions of Americans.

It is my opinion that both the Department of Treasury and Congress have allowed a few cases of extreme abuse to influence their thinking and blur their vision as to the needs for a sound Private Pension System. The Private Pension System has been viewed as an expensive tax expenditure. Contrary to popular belief, there is not a dollar-for-dollar loss to the Treasury for current deductions and exclusions. Studies have indicated that after adjustment for interest and inflation the Government will eventually collect between 64 and 72% of the taxes initially deferred.

A Private Pension System is a vital component in providing lifetime Retirement Income for Americans. Stability must be restored to that Private Pension System. The burden of constant change in tax law is most severe on the small employer, and threatens the retirement livelihood of many Americans.

Senator Kerry. Thank you very much.
Mr. Kaplan.

STATEMENT OF DANIEL KAPLAN, PRESIDENT, CENTRAL MASS MEDIA, INC., WORCESTER, MA

Mr. KAPLAN. Thank you, Senator Kerry. At the beginning of your remarks you mentioned that Massachusetts has the strongest economy of the 10 larger industrial States, and I think that as somebody who is an editor and a publisher from central Massachusetts, as well as an entrepreneur, it's been my observation that the primary ingredient in that strength in the last couple of years—we survived a recession in wonderful shape—has been the small business sector, on the jobs, as a number of people have pointed out, that come out of the small business sector, and because of that I think that it's great that you're on the Small Business Committee and that you're holding this hearing to determine the effect on that very important sector that the tax reform plan might have.

I also want to thank Frank Carroll, who I think is a great spokesperson for the small business sector, for inviting me to attend this hearing.

I want to address just one small part of the plan that's been put forth by the President, and the way I want to do that is just tell you a little bit of background about my business and how that plan, had it been in effect, would have affected my business.

I started my business 9 years ago. I had just graduated from college and I decided to start a magazine that would be about Worcester, MA. Nobody had ever done that before, and I thought it was just what Worcester needed. I didn't do any market research. I didn't raise nearly the money I should have; I just went out and did it, like a lot of entrepreneurs.

Luckily, I didn't know then what I do know now. I was just a naive kid who didn't know the first thing about business. I just wanted to have my own magazine. The way I did this, I went out and got a few volunteers and a couple of people I paid a very subminimum wage, and I guess I can admit that now, and in October 1976 we put out the first issue of what we called Worcester magazine. It took a lot of years and it took many all-nighters, and I think that now, 9 years later, I've finally caught up on my sleep.

Somebody once told me that you don't make a quick buck in Massachusetts and again I didn't believe them, so I kept trying, but 9 years later I can tell you that my company, I think, is successful. We call our company, now, Central Mass Media; we employ 75 people. We publish four different regional magazines in Massachusetts including Worcester magazine, and we publish a magazine in Rhode Island now. And last year and again this year, Inc. magazine named our company to the Inc. 500—that's a list that they put together each year of the 500 fastest-growing privately held companies in the United States.

Senator Kerry, you visited our office—I was out of town—I understand, a week or two ago, for an interview with one of our reporters, and the next time you come to visit us you'll have to come visit us someplace else because we are moving. In about 3 weeks the moving men are going to arrive at our office and take everything we own and take it to a new office and a new production facility that we built in downtown Worcester. Our brandnew home is a full floor of a 100-year-old building right on Main Street downtown. We've gutted the floor and created a facility that will allow our production department to expand by 60 percent. In our new space we expect to add 25 jobs in the next 2 years.

If President Reagan's tax plan had been in effect, it wouldn't have been possible. That is because we financed our new facility with an industrial revenue bond. We are one of many companies in Massachusetts that has used this source for funds at below-market rates, frankly, that otherwise we could not have afforded to borrow the money to create the facility and to grow.

The bond allowed us to take out a loan from a bank at a rate which we could afford, which was nearly 20 percent below the market rate which we otherwise would not have been able to pay.

I don't want to go too far without qualifying my support for the continuation of either the IRB Program or some similar program. I believe IRB's have their place, and that is in helping small businesses to grow where they otherwise could not borrow money to grow. But I must stop and add a qualification to my endorsement of the IRB Program. It has not always been used this way. Large corporations have used it; retailers have used it; I admit that many people—in many instances, it has been abused. But I would ask you and I would ask the Senate, in this plan: don't throw the baby out with the bath water.

I was kind of working out some statistics, which I have done many times because you have to fill out all these forms for the IRB Program, but the lost taxes to the Federal Government of our reduced rate loan come out to between $25,000 and $30,000 per year. That's taxes that, frankly, a bank in Boston is not going to be paying on the interest that they earn from us.

And I mentioned to you that we expect, in the next 2 years, to add 25 people—because of the IRB Program—to our payroll. Roughly, the payroll that that will add is between $400,000 and $500,000; and in very rough terms, the revenue generated for the Federal Government is between $80,000 and $100,000, so that a cost of $25,000 to $30,000 in this case made a very good investment. It returns on an annual basis; and, as it was pointed out, there is no end.

The jobs keep going—$30,000 lost initially, which decreases over the years as our interest goes down, generates an increasing revenue over the years which starts someplace around $100,000.

In conclusion, the industrial development program deserves—and I really mean small business deserves—the industrail revenue program. Adjust it. Eliminate the abuses and inappropriate uses. But keep the jobs, keep the opportunity that it has created, keep the growth that IRB's have provided for so many.

Thank you very much for the opportunity to share my views.

[The prepared statement of Mr. Kaplan follows:]

Testimony of

Dan Kaplan

President

Central Mass Media, Inc.

Worcester, Massachusetts

U.S. Senate Small Business Committee
Boston, July 3, 1985

I am honored to have the opportunity to speak and share my views regarding the tax reform plan which has been introduced by President Reagan.

I began my small business nine years ago. I had just graduated from college and I decided to start a magazine that would be about Worcester, Massachusetts. Nobody had ever done that before and I thought it was just what Worcester needed. I didn't do any market research. I didn't raise nearly the money I should have. I just went out and did it.

Luckily I didn't know then what I do know now. I was just a naive kid who didn't know the first thing about business. I just wanted to have my own magazine.

I got a few volunteers to help me and in October 1976 we put out the first issue of Worcester Magazine. It took years and it took many all nighters. I think now — nine years later — I have finally caught up on my sleep.

Today, my company, Central Mass Media employs 75 people. We publish four different regional magazines in Massachusetts and in Rhode Island. Last year and again this year Inc. Magazine named our company to the Inc. 500 — a list of the 500 fastest growing privately held companies in the United States.

In about three weeks the moving men are going to arive at our office one morning and take everything we own and move it to a new office and production facility in downtown Worcester. Our brand new home is a full floor of a 100-year-old building right on Main Street in downtown Worcester. We've gutted the floor and created a facility that will allow our production capacity to expand by 60%. In our new space we expect to add 25 jobs in the next two years.

And, if President Reagan's tax plan had been in effect it wouldn't have been possible.

That is because we financed our new facility with an industrial revenue bond. The bond allowed us to take out a loan from a bank at a rate which we could afford — nearly 20 per cent below the market rate we otherwise would have had to pay.

Let me not go too far without qualifying my support for the continuation of the IRB program. I believe IRBs have their place — in helping small businesses to grow where they could not within normal bounds.

I must stop here though and add a qualification to my endorsement of the industrial revenue program. It has not always been used thusly. Large corporations have used it. Retailers have used it. It has been abused. But — I implore — do not throw out the baby with the bath water.

The industrial development program deserves — no small business deserves — the industrial revenue program. Adjust it. Eliminate the abuses and inappropriate uses. But keep the jobs, keep the opportunity, keep the growth — that IRB's have provided for so many.

I thank you for the opportunity to share my experiences and views.

Senator **Kerry**. Thank you very much.

I'm going to ask that, again, we hold the record open with respect to this panel, and I will want to follow up in a couple of cases, particularly, on some questions if I may; but because of the shortage of time I do want to move to the next panel, if I can, right away. Thank you all.

The next panel—let me just comment, for Dan Kaplan, who I know has to run out and a couple of others, I just want to comment that I happen to be one of the very strong supporters and advocates of the IRB and IDB Program. When I was Lieutenant Governor. I led the fight nationally with a lot of Governors and others around the country to hold onto that program. And while I concur with the sentiment that there have been some abuses, there isn't any question in my mind that there are ways of dealing with whatever abuses did exist or have existed without throwing the program away. And it seems to me that had the Congress wanted to, it could have adopted any one of those options—limiting the size of the company that could use them, setting up certain criteria, or even delimiting where it could go geographically—to accomplish certain social goals. But I think that to turn around and simply get rid of it or to want to get rid of it is to ignore the very kind of growth that you've articulated, for which I congratulate you, where, for a minimal kind of loss of revenue on the one side, you produce so much more in terms of spinoff; not just in the income, not just in the taxes that are paid, the $80,000 you cited, but in the various services that are demanded by those people who have an additional dollar in their pocket, not to mention the lack of services which they require from the Government itself as a consequence of their unemployment or whatever their status might have been.

So I think it comes down to the core of some comments that we've heard throughout today's testimony about the need to have available capital. And when the cost of capital is as high as it's been, and particularly when compared with the cost of capital in other places and measured against the cost of labor in some of those other locales, if we're going to be serious about continuing their entrepreneurial spirit we talk about so proudly in creating the kind of investment that we want in this country, I think we need those kinds of programs.

So I can assure those of you who care about the part of it, that that will be one of the focuses of my energies in Washington in an effort to try to hold on to those kinds of incentives.

So thank you very much, Dan, for the good work you're doing and for taking time to share it with us.

This is our last panel, and I regret that we've been slightly compressed. These things inevitably happen, but the testimony, I think, has been most worthwhile, up until now.

The last panel is made up of Mr. Daniel Dennis from Daniel Dennis & Co.; Mr. Malcolm Fryer, Jr., from Dobroth & Fryer, from Lowell; Mr. Steve Spinelli from Jiffy Lube, Inc., in Springfield; and Mr. Stuart Shaines from Stuart Shaines, Inc., Portsmouth, NH, and I'm delighted to welcome all of you here and I thank you very much for taking time.

Why don't we begin with Mr. Dennis, if we can?

STATEMENT OF DANIEL DENNIS, CPA, DANIEL DENNIS & CO., BOSTON, MA

Mr. DENNIS. Thank you very much. I welcome the opportunity to testify before the Small Business Committee concerning the four tax proposals. However, looking at the changes proposed and looking at the four proposals, I decided to focus my attention on the President's proposal. Also, I decided, especially since hearing all the testimony, that many points that I had intended to cover, and which are in my written statement, I'm going to skip because one of the things I want to talk a little bit about is the impact on individuals. And I will also talk about business impact, but this is a two-sided program; the committee is on business, but it's still tied into the individual tax rate, so I think some time ought to be spent on that.

Just to kick off and talk about depreciation, an increase in the tax periods to recover the cost of fixed assets would not initially be beneficial to the small business community; however, the extent of the impact will be determined based on the level of fixed assets utilized by a particular company. The proposal to adjust the base cost of fixed assets by an inflation factor will add to the difficulty of the capital planning process. I believe that many small businessmen will be unduly confused by this provision. In addition, it is possible that this part of the proposal may have to be repealed in future years if there is a large loss of tax revenue, because more than 100 percent of the cost of the assets is being depreciated. In addition, I do think that the IRS will have trouble monitoring this inflation factor, and this fact alone may call for this part of the proposal to be repealed. I think this is a very difficult piece of the proposal. I think it's going to cause problems and cause some lost revenue, plus the complications of monitoring, both on the part of business and on the part of the IRS. And if you have any questions on that, we could talk to that a little bit.

However, in summary, I think that the negative impact of a longer write-off period will be more than offset by the decrease in tax rates, so I don't think that this, will be a problem by itself.

In addition, in terms of the repeal of the investment tax credit, it will have a negative impact, but I don't think this impact will influence the decision to purchase needed fixed assets. I do believe that if people need to purchase fixed assets, in fact, they will, and I don't think the ITC will be a major factor, or repeal of it, in terms of this decision.

In terms of the entertainment cost cap, I believe that $25 a meal is adequate. I think that this is a necessary cost. I think that people need to incur this type of cost to do business, but the costs could be limited. So I don't think it's essential to have unlimited entertainment costs, and I think a cap would not be a major factor in terms of small business people doing business.

Our area that people haven't talked about, however, is limited partnerships, which are also businesses. A major part of the interest limitation, of the $5,000-plus investment income, will have an impact on people who are partners in limited partnerships. It's my understanding that this is going to be viewed as a passive investment. Therefore, the interest part of a deduction in a limited partnership will flow through to the limited partners. This will impact his $5,000 limitation. This will have a major impact, as far as I'm concerned, on the housing starts of the country. I do believe that if investors cannot take this as a deduction, they will not make this investment, and therefore it will impact on the housing starts of the country. And I think this really needs to be looked at, whether or not limited partnerships are passive investments or whether or not they are investments in terms of the normal cost of doing business.

The taxation on fringe benefits—I think that this also is going to be a major problem. As my major occupation I run a CPA firm—I should have introduced myself; I'm a partner in Daniel Dennis & Co., a CPA firm—we have many small clients that we do accounting work and tax returns for. To put a burden of tax on fringe benefits will, No. 1, complicate their accounting system; No. 2, the employees will seek to recoup that cost by increased wages. I think there is going to be some poor labor relationship that will develop because of this.

I was kind of amazed—I didn't know that this was a big, untapped area of future revenues for the Government. I didn't think it would yield that much. But whether it yields a lot or not, I think you need to look at the complications and the poor labor relationship that this is going to cause. In addition, it will cause FICA taxes to go up, and I'm a firm believer that that tax is too high now. And to use a subterfuge to include fringe benefits in the wage package, and then tack FICA taxes on top of that, I think, is going to be a double burden to the businessman. I think that this has to be closely looked at, especially in terms of the small business person.

Now, one thing that wasn't alluded to much was the nondeductability of State taxes, both income taxes and real estate taxes, especially here in Massachusetts. And I'm kind of amazed that the penalists did not talk about that. It's difficult to talk about it because, obviously, this is the place where you're going to fund the reduced tax rates. But I think that here in Massachusetts that's really kind of unfair. I think that if it has to happen, it ought to be looked at. We ought to have these projections on revenue streams. We ought to have a clear indication of what this is going to mean, because I think it's going to be a major impact in Massachusetts and may have impact to discourage home ownership. As I thought about the originally, I thought it might be bad for an individual but it might be good for an investor; because as you know, an investor can still take the taxes and the interest off as a business expense, whereas a person owning the home will be limited on the interest expense and will not be able to take the taxes off. You may switch ownership—you may have a major impact in terms of people choosing to rent and not buy, but investors on the other hand, having the ability to buy property at a lower price and raise the rent—so it's all kinds of different scenarios that could happen. I'm not quite sure if these things have been seriously looked at, and they need to be looked at.

In summary, no one took a shot and said, "I think it's good or bad." I was amazed at that, too. Everyone pulled the proposals apart, and no one said, "Hey, let's go for it," as the President said. [Laughter.]

I have the same concerns that everyone else has—if these revenue streams are looked at and if people can nail them down a little bit and, if the overall impact is not negative to the economy of the country and of Massachusetts. I kind of say why not go for it? Because one of the groups of people I do represent, or know and talk to are many middle-class minority and black people. That group of individuals is on the upswing. Also there are a lot of minority people who are on the bottom of the economic ladder. I do think this tax plan will help those folks. It's questionable, as you move up through the brackets, whether or not you'll be helped or hurt depending on whether you earn $40,000, $50,000, $60,000 on up. I don't think the impact's going to be that great, actually, on minority individuals.

On the individual side of it, it may not be that bad. Business side, I can tell you—being a CPA, whatever the rules are, the guys will learn to play the game. I mean, it's just a big game that's going to be played, and we'll learn the rules, and we'll play the game within the rules, and I think business will take care of itself in terms of the new program. But I do think it may be beneficial to some individuals, especially those individuals on the bottom rung of the economic ladder. And I say, why not go for it?

Thank you very much.

[The prepared statement of Mr. Dennis follows:]

Testimony of Daniel Dennis, CPA
Tax Reform Proposals
U.S. Senate Small Business Committee
Boston, Massachusetts
July 3, 1985

I welcome this opportunity to testify before the U.S. Senate Small Business Committee concerning the proposed changes for our income tax system.

The changes being proposed in the four major proposals will impact every citizen and business in the United States.

The changes are very broad and interrelated; a complete analysis and comparison would be very difficult to perform in the time allotted. Therefore, I have decided to focus my testimony on the President's proposal as it relates to Small Businesses and to offer a brief discussion on how his proposal impacts individual tax payers.

Business

Corporate Rates - Ordinary Income

The President's proposal to reduce corporate rates to a maximum of 33% on a sliding scale will be very beneficial to Small Businesses. This will allow for increased profits to be reinvested without a disproportionate share going for income taxes. This will greatly aid the Small Business community and also the economy of Massachusetts.

Depreciation

Increasing the time period to recover the cost of fixed assets may not initially be beneficial to the Small Business community;

however, the extent of the impact will be determined based on the level of fixed assets utilized by a particular company. The proposal to adjust the base cost of fixed assets by an inflation factor will add to the difficulty of the capital planning process. I believe that many Small Business men will be unduly confused by this provision. In addition, it is possible that this part of the proposal may have to be repealed in future years if there is a large loss of tax revenue, because more than 100% of the cost of the assets is being depreciated. In addition, the IRS may find that this provision is too difficult to monitor.

In summary, however, the negative impact of this provision may be more than off-set by lower tax rates.

Investment Tax Credit

The repeal of the investment tax credit will have a negative impact; however, it probably will not influence the decision to purchase needed fixed assets.

Entertainment Cost Limitation

I do not believe that the cap on entertainment cost will have a major impact on most small businesses. Costs of this nature are necessary to conduct business, but not essential, and can be limited.

Limited Partnership

The proposal to have interest expenses flow through to a limited partner in a real estate partnership and be subject to the interest deduction limitation will have a major negative impact on real estate development. Many Small Business men invest their profits from their business into real estate. This proposal could seriously impact the housing stock of the country. I would be opposed to this provision.

Taxation of Fringe Benefits

The proposal to tax employees' fringe benefits would be counterproductive for the employees of Small Businesses and the business itself. It is probable that the employees would seek increased wages to cover the increase in taxes. The resulting poor labor relation would far outweigh the increased tax revenue that this would yield. In addition, this would probably cause the FICA taxes to increase. This tax is too high now and would add an additional burden to the Small Business.

Individuals

Non-Deductability of State and Local Taxes

This provision would have a major negative impact on the citizens of Massachusetts. It would require the citizens of our State to pay a disproportional amount of Federal taxes when compared to other states that have low or no state taxes. In addition, it would negatively influence the decision on home ownership.

States and cities that derive the bulk of their revenue from income and property taxes would be placed at a disadvantage versus other localities. This could cause a severe economic impact in these localities. Even if Massachusetts could adjust to this situation, the transitional period would be severe and would cause a greatly reduced level of services in all areas of state and city government. I understand that this is the major area to fund the reduced tax rates, but it is unfair, and if it is necessary, then the implementation should be in stages.

Summary

The President's proposal is very comprehensive and in some ways very appealing. I do think that it would be beneficial to low wage earners and would close some loopholes to wealthy individuals. Many small businesses, especially those who do not make large fixed asset investments, will be aided. This proposal may work if enacted as is without special interest groups pulling it apart.

Senator KERRY. Thank you, Mr. Dennis, I appreciate that.
Mr. Fryer.

STATEMENT OF MALCOLM FRYER, JR., PARTNER, DOBROTH & FRYER, LOWELL, MA

Mr. FRYER, Thank you, Senator, I am Mal Fryer, a partner in Dobroth & Fryer. We are a real estate development firm located in Lowell where, as many of you know, a great amount of rehab has been done in the building of the city and in the projects that have been done.

I would like to direct my comments specifically at four parts of the proposed tax plan, realizing that their are numerous other items that affect us, but sensing that these four items will have the most serious effect, not only on what we are going to be doing but what we have already done. Real estate seems to be the big bad boy in this current proposal, and they think that there's a fact cat out there that can be tapped. I'd like to just walk my way through my comments here so that we can see the effect of what the various proposed tax plan itesm could have on the rehabilitation of Lowell and a lot of other cities which I know you have been concerned with.

The first three items I would like to mention are the investment tax credit and the cancellation of it on the proper rehabilitation of historic properties; the second item is the drawing out of the depreciation schedule for these properties from 15 to 28 years, and the third item is the addition of the "at risk" rules to real estate investment, which would cause the limited partners to assume their share of the risk of the investment as opposed to the way it is now stated.

I'm not sitting here today attempting to be an expert in accounting or law; that's what we hire those fellows for, but I do sit here as an entrepreneur who has stuck his neck out along with his partner in trying to do something which we believe will be successful, using the rules that the game was played by when we started. And that's one of our concerns on the fourth item.

The administration asks us to stimulate the economy, to go out and rehab buildings and give us this tax credit and do all these other things, and now they say that's going to be a windfall, so we're going to tax that windfall that you've been working under the last 4 years. It seems to me that there's something blatantly unfair with that kind of an approach.

Any real estate investment is like a house of cards. You pull one card and it all collapses; and it's fragile until you pull it, but it stands strong if you leave all the pieces together. We have been working since 1981 to put together a project purely with private enterprise in the redevelopment of an old building in an older community attempting to help itself. We have received, fortunately, much recognition for our efforts and have only now begun to be successful in the leasing of the property so that we can see the light at the end of the development tunnel.

The Wannalancit Office & Technology Center, formerly the Wannalancit Textile Co, is a complex of four five-story brick buildings located along two canals in downtown Lowell. These buildings contain 400,000 square feet of what we used to call old mill space but what is now called new high-technology and office space.

We have as our partner a small bank, the Woburn Five Cents Savings Bank in Woburn, MA. The bank provides the equity and some of the debt needed to carry the project. We have used some industrial revenue bonds and have spoken with your predecessor and Congressman Shannon on many occasions on the keeping of the IRB's. But that is not one of the key issues I am emphasizing today.

The entire project is financed with private funds. Our success to date has enabled use to attract 13 tenants, including the National Park Service, with a total of 200,000 square feet now leased.

I'm skipping over some of my commentary here about how much moneyh is in the project at this time.

In the structuring of our financial and leasing package, we have used the existing tax laws; first, to motivate investment in our property, and second to produce a low enough rent to be attractive to the markeplace. We have adhered to the historic certification process and we have met all the guidelines in our renovations. We have struck by the rules that have been in effect as we have put together our construction financing, structured our limited partnership packages, and have begun permanent financing. The President's proposal as it affects the investment tax credit, the depreciation and the "at risk" rules will eliminate the structure of our financing as it has been created for every phase of the project. Unfortunately, we are not completely finished with our construction, leasing, and permanent financing, and probably will not be before January 1, 1986, when supposedly the rules change. We will have to go back to our financiers and redo our mortgages. They require that we have limited partnerships, which we are selling in order to recoup the investment tax credits. We'll have to go to those limited partners and change the scope of our projections and the structure of their investment, and we are in the process of selling the third and fourth phases of the project now, and it has to change. What's the ball game going to be next time?

Some might easily say that the tax benefits of such a project should only come into effect once the economics of the project have proven sound. On such a project as Wannalancit, all of the financial aspects play together and the economic soundness of the project is justified because of the quality of the financing we can attract, and the private investment opportunity which attracts the limited partner. You cannot separate one from the other.

As an example of how our small business, which employs 22 people, can generate other small business in a community such as Lowell, I'd like to give you some history of our facility.

In October 1980, the Wannalancit Textile Co. unfortunately closed its doors, leaving 170 people available to the labor market. Our 13 tenants now employ some 400 people in jobs which might not otherwise have come to Lowell if it had not been for our ability to produce a quality product at a reasonable rent.

An example of the effect of our entrepreneurial effort is the spinoff investments which are being generated by the small tenants. Eight of these tenants are new companies recently funded by venture capital organizations. This spinoff investment is in excess of

$20 million by those firms over the past 3 years. Those are small businesses seeking and seeing opportunity to locate in a resurging community and a renovated building. A list of our tenants is included in the material presented to you.

A similar example of our activity is happening throughout the city of Lowell, is happening in Lawrence and Fall River and cities throughout the Northeast. In Lowell, as you might know, there was $150 million of private investment generated over the past 5 years, mostly due to the investment tax credit and the rehab of buildings.

We believe that Wannalancit, if the President's tax proposal gets enacted, will suffer severely due to the items I have mentioned. We probably also will not see too many more entrepreneurs willing to tackle the rehab of old properties in other communities. We are pleased with what we have accomplished, but we think it's in jeopardy should the President's tax package be enacted as proposed. We believe that any project such as ours, which was started before the tax package gets passed, should be "grandfathered."

In summary, we believe that, first, the maintenance of the investment tax credit for truly historic renovation should be maintained. Step up depreciation, if such a need is required, on a gradual basis rather than one big jump, all at once. We do not at all change the "at risk" rules as they affect limited partnership investments in real estate. Certainly, do not tax as "windfalls" those successful activities generated by the administration's previous incentive programs. And, as I've mentioned before, we believe that "grandfathering" of those activities currently underway should be maintained.

Thank you.

[The prepared statement of Mr. Fryer follows:]

Dobroth & Fryer

TESTIMONY
as prepared by

MALCOLM F. FRYER, JR., PARTNER
DOBROTH & FRYER

BEFORE THE U. S. SENATE COMMITTEE ON SMALL BUSINESS

July 3, 1985

Dobroth & Fryer

July 3, 1985

The Honorable Lowell Weicker, Jr., Chairman
and
The Honorable John Kerry
United States Senate
Committee on Small Business
Washington, D. C. 20510

Dear Senators Weicker and Kerry:

I am pleased to present to you this package of information about the Wannalancit Office & Technology Center and the City of Lowell, and to give you specific examples of how various incentives have been used to redevelop an old building and help a City turn itself around. Included in this packet of material are:

- A Wannalancit Office & Technology Center brochure
- A list of the Wannalancit Tenants
- A brochure about Lowell
- A brochure from the Lowell Plan which shows other things which are going to happen in this City.

I sincerely appreciate the opportunity which you have given me to bring this material before you and to discuss with you the effects upon our small business of some of the items included in the President's proposed tax changes.

Sincerely,

Malcolm F. Fryer, Jr.

MFF/ek

Enclosures

REAL ESTATE DEVELOPMENT — BROKERAGE — PROPERTY MANAGEMENT
600 Suffolk Street, Lowell, Massachusetts 01854 (617) 937-9955

I would like to direct my comments specifically at four parts of the proposed tax plan, realizing, of course, that numerous items will affect us, but sensing that these four items will have the most serious effect, not only on what we are going to be doing, but what we have done.

Three of these items are:

- the cancellation of the Investment Tax Credit on the proper rehabilitation of historic properties;
- the drawing out of the depreciation schedule from fifteen (15) to twenty-eight (28) years;
- and the addition of the "at risk" rules to real estate investments.

I do not sit here today attempting to be an expert in all of the detailed ramifications of each of these aspects of the proposal. That's what we pay attorneys and accountants to advise us about.

I do sit here, however, as an entrepreneur who, along with his partner, stuck their necks out to try something which we believe will be successful using the rules that the game was played by when we started.

It appears now that the rules might be changed while the game is still in progress. I think the writers of the Tax Proposal call this changing of the rules a "windfall", which is my fourth item of concern.

For the past three years we have played by the administration's rules to stimulate the economy, and now that we might be seeing some success because we followed those rules, we get slapped with a "windfall" profits tax. Seems to me that there is something blatantly unfair with that approach.

Any real estate investment is much like a house of cards. When they are working together, all of the parts hold up well but when any one card is pulled, the fragility of the house of cards becomes evident.

We have been working since 1981 to put together a project purely with private enterprise in the redevelopment of old buildings in an older community attempting to help itself. We have received, fortunately, much recognition for our efforts and have only now begun to be successful in the leasing of the property so we can see the light at the end of the development tunnel.

The Wannalancit Office & Technology Center, formerly the Wannalancit Textile Company, is a complex of four, five story brick buildings located along two canals in downtown Lowell. These buildings contain 400,000 square feet of what we used to call 'old mill space' but what we now call "new high tech and office space".

We have as our partner in this project the Woburn Five Cents Savings Bank of Woburn, Massachusetts. The bank provided the equity and some of the debt needed to carry the project. We have used some Industrial Revenue Bond financing but only in a small way. The entire project is financed by private funds. Our success to date has enabled us to attract thirteen tenants, including the National Park Service, with a total of 200,000 square feet now leased in the Complex.

Using Wannalancit as the private investment leverage, the City of Lowell received UDAG and State grants and put in City funds, along with $700,000 of our money to build a 1,250 space parking garage for the City, which in turn provides us with some of the spaces we need for our tenants. I am sure that you all are well aware of the tremendously successful delivery system involving our Federal, State and local leadership working with local business to make things happen in Lowell.

The financial numbers on our project are:

Private permanent or construction loans	$20,350,000.
UDAG to be repaid by Wannalancit and developer equity loan for garage	2,400,000.
Limited Partners' investment	4,930,000.
General Partners' loans and equity	3,165,000.
Total Project Investment	$30,845.000.

In the structuring of our financial and leasing package, we have used the existing tax laws - first to motivate investment in our property and - secondly to produce a low enough rent to be attractive to the marketplace.

We have adhered to the Historic Certification process and we have met all of the guidelines in our renovations. We have stuck by the rules that have been in effect as we have put together our construction financing, structured our limited partnership packages, and have begun permanent financing. The President's proposal as it affects the Investment Tax Credit, depreciation and the "at risk" rules will eliminate the structure of our financing as it has been created for each phase of the total project. Unfortunately we are not completely finished with our construction leasing and permanent financing, and probably will not be before January 1, 1986, when supposedly the rules change. We will have to go back to our financiers and redo our mortgages. We will have to go to our limited partners and change the entire scope of our projections and the structure of their investments hoping all of the time that things will still hold together.

Some might easily say that the tax benefits of such a project should only come into effect once the economics of the project have proven sound. On such a project as Wannalancit, all of the financial aspects play together and the economic soundness of the project is justified because of the quality of financing we can attract and the private investment opportunity which attracts the limited partner. You cannot separate one from the other.

As an example of how our small business, which employes twenty-two people, can generate other small business in a community such as Lowell, I would like to give you some history of our facility.

In October of 1980, the Wannalancit Textile Company closed its doors leaving 170 people available to the labor market. Our thirteen tenants now employ some four hundred people in jobs which might not otherwise have come to Lowell if it had not been for our ability to produce a quality product at a reasonable rent.

An example of the effect of our entrepreneurial effort are the spinoff investments which are being generated by the small tenants. Eight of these tenants are new companies recently funded by venture capital organizations. This spinoff investment is in excess of $20 million by those firms over the past three years. Those are small businesses seeking and seeing opportunity to locate in a resurging community and a renovated building. A list of our tenants is included in the material presented to you.

We believe that Wannalancit, if the President's tax proposal gets enacted, will suffer severly due to the items I have mentioned - the Investment Tax Credit cancellation, the extension of the depreciation schedule, and the "at risk" rules on real estate investment. We probably also will not see too many more entrepreneurs willing to tackle the rehabilitation of older properties in other communities. We are pleased with what we have accomplished. We think that it is in jeopardy should the President's Tax Bill be enacted as proposed and we believe that any project which was started before the tax package gets passed should be 'grandfathered'.

Our specific thoughts on the Tax Proposals for future projects would be:

1. Maintain the Investment Tax Credit at some level for truly historic restorations.
2. Step up depreciation, if such a need is really required, on a gradually increasing basis rather than all in one jump, and treat all properties in the same manner.
3. Do not at all change the "at risk" rules which are now in place relative to real estate investments.
4. Certainly do not tax as "windfalls" those successful activities generated by the Administration's previous incentive programs, and
5. (as I mentioned before) "grandfather" those activities properly begun before the final tax package gets approved.

Thank you for this opportunity to present our thoughts to you.

Senator **Kerry**. Thank you, Mr. Fryer. I'd like the record to note that I've had the pleasure of visiting the Wannalancit Building, which is really one of the outstanding examples of what can be done but which clearly can only be done when you have a very special kind of cooperation between the private sector and the public process, if you will. And I think it really shows how important some of the things that Mal has talked about from the investment tax credit for truly historic buildings, or some of the other available tools, and I can assure you that we'll watch those very, very carefully and factor those thoughts into the process.

Mr. Spinelli.

STATEMENT OF STEVE SPINELLI, JIFFY LUBE, INC., SPRINGFIELD, MA

Mr. **Spinelli**. My name is Steve Spinelli. I am a small retail businessman doing business in Massachusetts and Connecticut. I am president of the Jiffy Lube Association of franchisees, representing almost 300 independent small business owners. Additionally, I've had a wide range of discussions with small businesspersons in western Massachusetts.

I think, more accurately, I'm the poor kid that Mr. Nieses talked about earlier. I capitalized my company with $1,000 and a ridiculous amount of debt about 3 years ago. This year we'll open our 10th and 11th stores, and we'll exceed $5 million in sales. I don't know if I'm happy or unhappy, but I'll report that my Federal income tax burden reached six figures this year. [Laughter.]

Senator **Kerry**. If you're unhappy, we've got plenty of suggestions on what you can do.

Mr. **Spinelli**. I listened very attentively.

The idea of fairness and simplification of the tax system is obviously sound, and in many ways the President's tax proposal is consistent with the historical, legislative, and cultural position of fostering small business. However, I believe there are correctable philosophical and economic inconsistencies in the proposal.

Equity capital in small business is typically generated through the owners and their friends and relatives. Therefore, lowering the personal tax brackets should place more funds in the hands of individual equity investors. Concurrently, the reduction in the corporate tax and maintenance of the graduated corporate income tax represents a positive small business investment scenario and is philosophically consistent.

The single biggest issue in the proposal is the complete elimination of the investment tax credit. Most small businesses that fail do so in their first 5 years. The primary reason for this failure is thin capitalization, aggravated by startup losses. The President's proposal argues that the investment tax credit is "front loaded" and therefore is unfair. The administration's answer to the problem is an indexed depreciation method. Herein lies the inconsistency. If small businesses fail due to thin capitalization and startup losses, then their problems are "front loaded." To completely repeal the investment tax credit is inconsistent with the graduated corporate income tax and is a deterrent to small business startup and expansion. Please allow me to offer an alternative scenario.

I would propose a graduated investment tax credit. The first $25,000 of capital equipment would receive a 10-percent investment tax credit; the second $25,000, an 8-percent investment tax credit; the third $25,000, a 6-percent investment tax credit, and no investment tax credit for capital equipment over $75,000. I would further limit the investment tax credit to capital equipment purchased via equity infusion or profit plowback. I suggest that the following would occur.

The investment tax credit would encourage investment without creating excessive shelters because of the limited dollar allowance. Also, because of the equity qualification, the small businessperson would be encouraged to capitalize more soundly. More equity, less leverage. The small businessperson might even be able to coax greater equity from investors because some profit will be available for return to investors via the 10-percent dividend exclusion. With expanding Federal deficits, I contend there is even greater potential for the small businessperson to be crowded out of the capital marketplace. The graduated investment tax credit gives us a fighting chance to be competitive with Government and big business for capital.

The elimination of accelerated depreciation and its replacement with CCRS also causes me some concern. The small businessperson will be hurt very much by this. Many small businesses must lease both real and personal property. The elimination of accelerated depreciation will inflate lease expense to the small business. Also, the realignment of depreciation categories with loose definitions of category placement will throw much equipment into category 4, which I believe is a 7-year schedule. The small business will be faced with bureaucratic entanglements to reassign his depreciable assets. Even if he is successful, the time and effort will be disproportionately burdensome to the small businessperson. I agree that present depreciation schedules are not in tune with true economic values of assets, and adjustments are necessary. However, I would request much greater detail in category analysis and placement than is presently evident.

Let me give you an example. I talked to a small business owner, a restaurant owner in Springfied who has several thousands of dollare of dishwashing equipment which he has to replace every 3 or 4 years. Reading the President's proposal, I believe that equipment will be placed in the 7-year category. He's in trouble.

In conclusion, gentleman, let me say that my proiority is encouraging capital formation and expansion as has been the historical position of the United States. I might also add, on a personal note, that I asked my 70-year-old father to come here with me today. He worked for most of his life 14 hours a day as a laborer. Today he works in my business. He probably gets paid less from me than he did—it's because he won't take any more money. But I wanted to prove to him that the lessons he taught me were well-learned.

[The prepared statement of Mr. Spinelli follows:]

STATEMENT OF STEVE SPINELLI, JIFFY LUBE, INC., SPRINGFIELD, MA

My name is Steve Spinelli. I am a small businessman doing business in Massachusetts and Connecticut. I am President of the Jiffy Lube Association of franchisees representing almost 300 independent small businessowners. Additionally, I've had significant discussions with a wide range of small businesspersons in Western Massachusetts.

Gentlemen......

I believe in the American dream and I am commited to the belief that small business is the manifestation of the hope and spirit that makes that dream possible.

The idea of fairness and simplification of the tax system is obviously sound, and in many ways the President's tax proposal is consistent with the historical legislative and cultural position of fostering small business. However, there are correctible philosophical and economic inconsistencies in the proposal.

Equity capital in small business is typically generated through the owners and their friends and relatives. Therefore, lowering the personal tax brackets should place more funds in the hands of individual equity investors. Concurrently, the reduction in the corporate tax and maintenance of the graduated corporate income tax presents a positive small business investment scenario and is philosophically consistent.

The single biggest issue in the proposal is the complete elimination of the Investment Tax Credit. Most small businesses who fail do so in their first five years. The primary reason for this failure is thin capitalization aggrevated by start up losses. The Presidents' proposal argues that the Investment Tax Credit is "front loaded" and is therefore unfair. The administration's answer to the problem is an indexed depreciation method. Herein lies the inconsistency. If small businesses fail due to thin capitalization and start up losses, then their problems are "front loaded." To completely repeal the Investment Tax Credit is inconsistent with the graduated corporate income tax and is a deterent to small business start up and expansion. Please allow me to offer an alternative scenario.

I propose a graduated Investment Tax Credit. The first $25,000. of capital equipment would receive a 10% Investment Tax Credit, the second $25,000. an 8% Investment Tax Credit, the third $25,000. a 6% Investment Tax Credit, and no Investment Tax Credit for capital equipment over $75,000. I would further limit the Investment Tax Credit to capital equipment purchased via equity infusion or profit plow back. I suggest that the following would occur:

The Investment Tax Credit would encourage investment without creating excessive shelters because of the limited dollar allowance. Also, because of the equity qualification, the small businessperson would be encouraged to capitalize more soundly; more equity and less leverage. The small businessperson might even be able to coax greater equity from investors because some profit will be available for return to investors via the 10% dividend exclusion. With expanding federal deficits, I contend there is even greater potential for the small businessperson to be crowded out of the capital marketplace. The graduated Investment Tax Credit gives us a fighting chance to be competitive with government and big business for capital. Gentlemen, a graduated Investment Tax Credit with an equity qualifier would send a message to small businesspersons - Washington believes in small business which is thoughtfully conceived and soundly capitalized.

The elimination of accelerated depreciation and its replacement with CCRS also causes me some concern. The small businessperson will be hurt most by this. Many small businesses must lease both real and personal property. The elimination of accelerated depreciation will inflate lease expense to the small business. Also, the realignment of categories of depreciation with loose definitions of category placement will throw much equipment into category 4, a seven year schedule. The small business will be faced with bureaucratic entanglements to reassign his depreciable assets. Even if he is successful the time and effort will be disproportionately burdensome to the small businessperson. I agree that present depreciation schedules are not in tune with true economic life of capital assets and adjustments are necessary. However, I would request much greater detail in category analysis and placement then is presently evident.

For example; Restaurant equipment is listed in the seven year depreciation category. In discussions with restaurant owners in Springfield, many have thousands of dollars worth of dishwashing equipment which is replaced every 3 to 4 years. With the Presidents' proposal, the asset will be placed in a 7 year depreciation category.

In conclusion, gentlemen, let me say that my priority is encouraging capital formation and expansion as has been the historical position of the United States government.

I asked my 70 year old father to attend this hearing with me today because he is the one that taught me that American dreams were made of hard work and desire. I wanted him to see that his beliefs are being perpetuated by our leadership in Washington.

Thank you for this opportunity to speak with you.

Senator. KERRY. Thank you very, very much. I appreciate it. And finally, Mr. Shaines.

STATEMENT OF STUART SHAINES, STUART SHAINES, INC., PORTSMOUTH, NH

Mr. SHAINES. My remarks indicate good morning, but I'll try good afternoon. And I feel no discrimination in the fact that I'm from New Hampshire. So please convey my best wishes to associate, Senator Rudman.

I am Stuart Shaines. I represent a corporation located in Portsmouht, NH, and I'm here on behalf of my capacity of five men's wear retail stores in northern New England. I am a member of the Small Business Association of New England, but more particularly, a member of the board of directors of the Independent Stores Division of the National Retail Merchants Association.

NRMA, as it is named, is the Nation's largest trade association for the general merchandise retail industry. Our members operate 40,000 leading department chain independent and specialty stores in all 50 States of the Nation. Our annual sales exceed $150 billion, and our members employ more than 3 million workers. Accordingly, any fundamental restructuring of the Nation's tax laws is of significant consequence to the organization, its members, its employees, and its families.

I would like to provide you briefly with some views on several issues that have surfaced. I am very concerned about efforts to repeal or eliminate the graduated corporate tax rate. I would also like to talk about the capital cost recovery, which is of vital interest to small business retailers, as you heard earlier this morning, and more particularly, on the proposed taxation of employer-provided benefits.

On May 28, President Reagan proposed a plan which he stated "is clear, simple, and fair for all, regarding the American tax system." And I wish to counter that in 1935, 50 years ago, President Roosevelt proposed graduating the corporate tax structure on the grounds that "smaller corporations should not carry burdens beyond their powers." I could rest my case at this point. [Laughter.]

However, the revised Treasury Department proposal, Treasury II, unlike its predecessor, would retain a graduated corporate tax structure. Under Treasury II, corporations with taxable incomes under $75,000 would pay 15 percent; 18 percent on the next $25,000, and 25 percent on taxable income beyond $50,000 and under $75,000. Obviously, Kemp-Kasten and Treasury II are preferable over Treasury I.

The policy that has been continued regarding taxation today is an integral component of our Tax Code. Graduated rates allow smaller corporations to pay lower taxes than large competitors. As a result, smaller businesses are provided with an important source of operating and expansion income.

Any significant reduction in the availability of working capital would result in major problems for the small business community. Further, small business accounts for approximately 40 percent of the gross national product and two-thirds of all new employment.

The entrepreneurial spirit, exemplified by the small business community, must be encouraged, not stifled by Federal tax policies which run counter to the interests of small business. The elimination of a graduated corporate tax structure would be extremely detrimental—not only to the small business community, but to the economic growth of the Nation as a whole.

I strongly recommend the committee look closely at the cost recovery proposals and evaluate them. Preliminary reports evaluating Treasury II's repeal of the ITC and the changed depreciation system indicate that the effective tax rate on equipment would be increased, while the effective rate on buildings would be substantially lower. This is an appropriate first step toward achieving a tax system which is less discriminatory in its treatment of different types of capital investment. Under current law, substantial differences exist between the depreciation systems for equipment and buildings which should be eliminated.

As you all know, retail industry is a labor-intensive industry.

The taxation of employee benefits is a subject which should be handled on a separate track from individual and corporate taxes. Issues in this area are, indeed, complex. They should be carefully analyzed to ensure that any proposed changes are in line with the national goals for the employee welfare benefit. One example of an area is the employer-paid health plans. Under Treasury II, the first $10 of a monthly health insurance premium for individuals and $25 a month in premiums for families would be taxed. This results in an additional tax liability ranging from $18 to $105. Although such amounts do not represent signficant financial burden to an employee, this could set the stage for a larger tax. And second, the tax is regressive, placing the greatest tax burden on those least able to pay.

Treasury II's proposal does not aid in the containment of rising medical costs, an advantage of the "tax cap" provided. All premiums in excess under Treasury I would be, of a certain amount, taxable, but would tend to curtail overly extravagant plans.

Finally, I am concerned about a "perk," as so-called, one of the more significant values that retail employees place on their list of benefits. This is known as a company-support discount. Our employees are granted discounts throughout the Nation on the items of clothing and items that they can purchase from the stores where they work. Small business already pays its more than fair share directly and through its employees in taxation. To consider taxation of employee benefits beyond where they are now taxed would be excessive.

I support the committee's interest in tax reform and simplification for small businesses, and I sincerely encourage the members of the committee to be active participants in the tax reform debate.

Thank you. I appreciate your kindness.

[The prepared statement of Mr. Shaines follows:]

STATEMENT
OF
STUART SHAINES
OF
STUART SHAINES, INC.
BEFORE THE
SENATE SMALL BUSINESS COMMITTEE
JULY 3, 1985
BOSTON, MASSACHUSETTS

Good morning. My name is Stuart Shaines. I am President of Stuart Shaines, Inc., a corporation located in Portsmouth, New Hampshire. Today I am here to testify on behalf of myself in my capacity as owner of five retail men's wear stores in northern New England. I would like the record to indicate that I am a member of the Small Business Association of New England (SBANE) and also a member of the Board of Directors of the Independent Stores Division of the National Retail Merchants Association (NRMA). SBANE is a trade association active in representing the small business community here in New England, while NRMA is the nation's largest trade association for the general merchandise retail industry. The vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million.

Today, I would like to provide the Committee with my own views on several issues that have surfaced during the current tax simplification debate. Most important, I am very concerned about any efforts to repeal or eliminate the graduated corporate tax rates from the tax code. I would also like to provide the Committee with my general views on the issue of the capital cost recovery which is also of interest to small business retailers and on the issue of the proposed taxation of employer-provided benefits.

Last November the Department of Treasury released its report to the President recommending certain changes in the tax code to promote fairness, simplicity and economic growth. That study (Treasury I) was generally well received by most labor-intensive businesses, including the retailing industry. However, this proposal and the Bradley-Gephardt bill, one of the more prominent bills that has been introduced in the tax reform debate, recommends that the existing graduated tax rate structure be eliminated. For small business retailers the proposed elimination of the graduated rate structure would result in more than a two-fold increase in taxes to those small businesses with less than $50,000 of taxable income. Those with more than $50,000 but less than $150,000 of taxable income would have less severe but nevertheless significant tax increases should the structure be eliminated.

Another well-known bill introduced by Congressman Jack Kemp and Senator Robert Kasten takes a different tack in recommending that the graduated corporate tax structure be retained. Further, the Kemp-Kasten bill proposes modifications which are actually an improvement over current law. Under Kemp-Kasten, the first $50,000 of taxable income would be taxed at 15 percent; taxable income between $50,000 and $100,000 would be taxed at 25 percent; and taxable income over $100,000 would be taxed at 35 percent. Current law sets a rate 15 percent on the first $25,000; 18 percent on the next $25,000; 30 percent on taxable income between $50,000 and $75,000, and 40 percent on the next $25,000 up to $100,000.

On May 28, 1985, President Reagan endorsed a revised Treasury Department proposal (Treasury II). That proposal, unlike its predecessor, would retain a graduated corporate tax rate structure. Under Treasury II, corporations with taxable income under $75,000 would pay taxes of 15 percent on taxable income up to $25,000; 18 percent on the next $25,000 of taxable income; and 25 percent on taxable income between $50,000 and $75,000. Current law and Treasury II phase out the graduation to a 46 and 33 percent rate respectively. Of the two cited alternatives which call for the retention of graduated rates, Kemp-Kasten is more beneficial to the small business community on taxable income between $25,000 and $50,000 and between $75,000 and $100,000, while Treasury II is an improvement over Kemp-Kasten on taxable income exceeding $100,000. Obviously, Kemp-Kasten and Treasury II are preferred over Treasury I.

In 1935, President Roosevelt proposed graduating the corporate tax structure on the grounds that "smaller corporations should not carry burdens beyond their powers." That policy has been continued to the point where today it is an integral component of our tax code. Graduated rates allow smaller corporations to pay lower taxes than their large competitors. As a result smaller businesses are provided with an important source of operating and expansion income. Any significant reduction in the availability of working capital would result in major problems for the small business community. Further, small business accounts for about 40 percent of the gross national product and two-thirds of all new employment. The entrepreneurial spirit, which is exemplified by the small business community, needs to be encouraged, not stifled by federal tax policies which run counter to the interests of small business. The elimination of the graduated corporate tax structure would be very detrimental not only to the small business community, but to the economic growth of the nation as a whole.

Although I have not had adequate time to complete a detailed analysis of each of the cost recovery rules provided in Treasury I and II as well as those in the Bradley-Gephardt and Kemp-Kasten bills, I do have some general comments which I would like to provide on the issue. First, the purpose of real tax reform is to move away from reliance on the tax code as a means of establishing an industrial policy that favors one industry over another to one that allows each corporation to pay its fair share while encouraging economic growth through a free market system. Over the years, a tax system has evolved which allows capital-intensive industries to pay generally low effective tax rates while labor-intensive ones have been overburdened with higher rates. For example, different treatment has been accorded to a manufacturer's principal capital asset — his equipment - - and a retailer's principal capital asset — the building which houses his stores. In order to ensure that any changes in the tax laws do not continue to favor capital-intensive over labor-intensive firms, I support the repeal of the Investment Tax Credit (ITC), together with the establishment of a depreciation system which treats both labor- and capital-intensive industries on a more equal basis.

I strongly recommend that this Committee look closely at the cost recovery proposals and evaluate them in this context. Preliminary reports evaluating Treasury II's repeal of the ITC and the changed depreciation system indicate that the effective tax rate on equipment would be increased while the effective rate on buildings would be substantially lower. This is an appropriate first step toward achieving a tax system which is less discriminatory in its treatment of different types of capital investment. Under current law substantial differences exist between the depreciation systems for equipment and buildings which should be eliminated.

The taxation of employee benefits is a subject which should be handled on a separate track from individual and corporate tax reform. Issues in this area are complex. They need a careful, comprehensive analysis to ensure that any proposed changes are in line with national goals for employee welfare benefit and pension plans. As an example of one area that needs extensive study is the area of employer-paid health plans. Under Treasury II the first $10 of monthly health insurance premiums for individuals ($120 per year) and $25 of monthly premiums for family coverage ($300 per year) would be taxed. This results in an additional tax liability ranging from $18 to $105 (15 percent of $120 and 35 percent of $300). Although such amounts do not represent a significant financial burden to an employee, this could set the stage for a larger tax. Second, the tax is regressive, placing greatest tax burden on those least able to pay. For example, a family earning $20,000 woul pay $45 in tax, or 0.23 percent of income; while families earning $50,000 and $80,000 would pay $75 and $105, or 0.15 percent and 0.13 percent of income, respectively. Third, the Treasury II proposal does not aid in the containment of rising medical costs, an advantage of the "tax cap" provided in Treasury I. Under the Treasury I proposal, all premiums in excess of a certain amount would be taxable, which would tend to curtail overly extravagant plans, which provide overuse and, in turn, increase medical costs. Finally, I am concerned about the tax on health premiums opening the door to taxing other mainstream benefits at some point in the future. Among benefits available to persons working in the retailing industry are company supported discounts. This "perk" is one of the more significant values retail employees place on their list of benefits. Is this to be taxed? Small business already pays its more than fair share directly and through its employees in taxation.

In conlusion, I support the Committee's interest in tax reform and simplification for small business and encourage the members to be active participants in the tax reform debate.

Mr. Chairman, thank you for the opportunity to appear here today. I would be happy to try to answer any questions you may have.

Senator **Kerry**. Thank you, Mr. Shaines, and I want to absolutely convince you that the fact that you are from New Hampshire had nothing to do with your replacement in this panel. In fact, we in Massachusetts think we've been more than generous; we've given you a lot of our businesses, we've given you half of our citizens to live there, and so we thought therefore, since we helped to make you first, we'd let you be last.

Mr. **Shaines**. Thank you, sir. [Laughter.]

Senator **Kerry**. Let me just say that everybody, as we conclude this—and again, the record remains open; I want to be able to submit some questions, particularly, I think, a few points that Mr. Dennis brought up and Mr. Fryer brought up. There is much to ask in this area, and I acknowledge your comments and the comments of the other people who have testified, that it's important that all of us within the Senate and particularly those of us on the Small Business Committee pay very close attention to this debate and are prepared to go to bat for you and for those things that make sense. I think in your final comments, Mr. Shaines, you underscore as you begin to broach things like the fringe benefits or the impact on health or whatever, that in each part of this there's a plethora of negative and positive impacts, all of which have to balance out. And some of these things may or may not be better discussed in the course of the whole process of tax reform.

But I think what is most important is that we, all of us, refrain from that natural tendency to be able to view our particular area of concern as the one in which there is the most significant interest, because as that gets magnified on a national basis, obviously, consensus becomes harder and harder and it gets more and more difficult to achieve the larger goal, which is creating a fair and simple system and, second, advancing the economic ability of the country and our communities to continue to go forward.

So I will watch that very carefully. The Finance Committee has begun its hearings. I am confident that Senator Weicker and Senator Bumpers are going to continue to want to weigh in in this significantly, and I just want to underscore finally my own personal, deeply held belief, that for a sector of our economy that is as critical as small business is, that provides the growth and most of the jobs, it is amazing to me—or perhaps it shouldn't be, after these years in the process—that it doesn't have easier access and perhaps larger-felt clout. And I think it's terribly important that we band together to make sure that we are not handicapping that ability of Mr. Spinelli or anyone else to make things work.

So on that note, I want to thank all of you for your patience, for taking your time, for sharing with us your prepared testimony, and I look forward to continuing this process in the months and in the weeks ahead. Thank you very, very much.

The hearing is adjourned.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at the call of the Chair.]

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